TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES

EIGHTY-NINTH CONGRESS

SECOND SESSION

ON

H.R. 14026

A BILL TO PROHIBIT INSURED BANKS FROM ISSUING NEGOTIABLE INTEREST-BEARING OR DISCOUNTED NOTES, CERTIFICATES OF DEPOSIT, OR OTHER EVIDENCES OF INDEBTEDNESS

MAY 9, 10, 11, 12, 19, 24, 25, 31; JUNE 1, 2, 7, 8, 9, 16, AND 23, 1966

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

MONDAY, MAY 9, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Ashley, Moorhead, Stephens, Gonzalez, Weltner, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Widnall, Harvey, Clawson, Stanton, and Mize.

The Chairman. The committee will please come to order.

We are meeting this morning for the purpose of considering H.R. 14026, concerning certificates of deposit and related matters.

(The bill, H.R. 14026, follows:)

[H.R. 14026, 89th Cong., 2d sess.]

A BILL To prohibit insured banks from issuing negotiable interest-bearing or discounted notes, certificates of deposit, or other evidences of indebtedness

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended by adding at the end thereof the following new subsection:

"(j) The Board of Directors shall by regulation prohibit insured banks from making or issuing any negotiable certificate of deposit, note, debenture, or other negotiable obligation which is issued at a discount, or is interest bearing, or otherwise yields any return."

Sec. 2. The amendment made by section 1 of this Act shall apply only with respect to obligations of insured banks incurred or issued after March 31, 1966.

The Chairman. The term "negotiable certificates of deposit" is a fancy label for a piece of paper which many suspect is a vehicle for the most ordinary type of misuse and abuses. Technically speaking, a negotiable certificate of deposit is a debt security evidencing a deposit liability of the issuing bank. It is a form of time deposit and is subject to the Federal Reserve Board's regulation Q as well as applicable reserve requirements. Maturities are as short as 30 days. CD's are insured up to the $10,000 FDIC limit and in negotiable form may be quickly disposed of by the original depositor. A secondary market has developed in CD's and CD's trade in this market at prices reflecting the reputation of the issuing bank, maturity schedules, and, most of all, prevailing interest rates.

One hundred years ago the banks were authorized to issue their own money and many of them did issue their own money. That money was very similar in purpose and effect to the CD's of today. How-

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ever, today's version is interest-bearing currency and could be just as prevalent over the country as the money that was issued by the banks before the War Between the States many years ago.

Negotiable CD's are a very recent innovation, having grown from virtually nothing in 1961 to over $17 billion of outstanding liabilities as of May 1966. Typically, a negotiable CD represents a large deposit by a business corporation of hundreds of thousands of dollars with a maturity of 1 year.

Current posted interest rates exceed 5 percent. Smaller CD's, both in negotiable and nonnegotiable form, are currently being promoted by commercial banks very aggressively and are being offered to savers and consumers in the form of certificates often called savings bonds.

While the CD must be considered innocent until proven guilty to the satisfaction of the Congress, substantial evidence gathered over the past year or so compels us at this time to drop other important matters and consider whether or not remedial legislation is necessary.

My bill, H.R. 14026, would prohibit the issuance by a federally insured bank of any negotiable certificate of deposit, note, debenture, or other negotiable obligation yielding a return. The purpose of this bill is to curb specific abuses that may be found and not to hamper or impair the use of financial instruments for legitimate purposes. I will welcome suggestions for modification as the testimony progresses. H.R. 14026 is thus a vehicle for discussion and testimony should not be limited to its precise terms.

It is not the only bill on this subject pending before the committee, and I am informed that members plan to introduce several additional bills this week.

This series of hearings represents the first full-scale public airing of a new problem—the CD problem—and will necessarily be extensive with all sides and points of view to be heard. We may run 2 weeks or more.

Some of the questions we will want to investigate involve the relationship between CD's and—

1. Monetary policy;
2. High interest rates;
3. The thrift industry;
4. Homebuilding and the mortgage market;
5. The Government securities market;
6. Bank safety and liquidity; and
7. Unlawful activities.

This morning our witnesses represent an important segment of the thrift industry. We will hear first Mr. Norman Strunk, of Chicago, Ill., executive vice president of the United States Savings & Loan League, and then Mr. Everett C. Sherbourne, representing the National League of Insured Savings Associations.

The committee will seek information from these witnesses whether the well-established public policy to encourage thrift and homeownership is being jeopardized or in any way impaired by the phenomenal growth of CD's in recent years. That the thrift industry has long been recognized as Congress' primary tool in mobilizing savings for home financing and home building is beyond dispute. Beginning with the act creating the Federal Home Loan Bank System in 1932, the Home Owner's Loan Act of 1933 establishing a system of

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federally chartered associations, and legislation in 1934 providing share account insurance, the savings and loan industry has carried out this congressional policy in a most satisfactory manner, and the industry has grown in assets to over $130 billion. The vast majority of associations are small, independent, locally owned institutions and it seems to me that Congress has a particular responsibility to make certain that these thrift institutions continue to effectively meet the housing needs of heir communities.

Thrifty people with savings accounts are better citizens and homeowners are better citizens. So we must be sure that the great goals of our thrift industry are not threatened by CD's.

Mr. Strunk, we are glad to have you, sir, and you may proceed as you wish.

You may identify yourself and identify the gentleman accompanying you for the record.

STATEMENT OF NORMAN STRUNK, EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS AND LOAN LEAGUE; ACCOMPANIED BY STEPHEN SLIPHER, STAFF VICE PRESIDENT AND LEGISLATIVE DIRECTOR, UNITED STATES SAVINGS & LOAN LEAGUE

Mr. STRUNK. Thank you, Mr. Chairman.

I am Norman Strunk, of Chicago, Ill., and I am executive vice president of the Savings & Loan League and I have with me, Mr. Stephen Slipher, of Washington, our legislative director.

We welcome this opportunity to express our views on the general subject of certificates of deposit and to discuss generally our views on the current situation in the savings market and the availability of money for homebuying and homebuilding.

We consider it most constructive that the distinguished chairman of the House Banking and Currency Committee has introduced H.R. 14026 and has called these hearings which will provide a much-needed spotlight on the spreading use of certificates of deposit within the commercial banking system—a development which appropriately may be viewed with considerable concern by the American people. It certainly deserves a searching inquiry by the committee of the Congress that has responsibility for legislation in the field of finance.

The United States Savings & Loan League represents more than 5,000 individual savings and loan associations. We are very familiar with the flows of savings, real-estate financing, and the needs of the country with respect to mortgage credit for homebuilding and homebuying. We do not claim to be experts in monetary theory and the money markets, but we can see the effect of the increasing use of certificates of deposit on savings flows and the effect on the amount and cost of money available to ordinary people who buy homes.

Our interest in certificates of deposit, however, is broader than the effect upon the cost of credit to individuals. This country needs a strong commercial banking system and we believe that any new development in the banking field which might in any way impair the usefulness, and particularly the soundness and liquidity of commercial banking is a matter of broad public interest and should be the subject of careful inquiry.

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We think that the sale by the large banks of negotiable certificates of deposit and the issuance of deposit certificates with definite maturities and long-term contractual promise to pay certain rates of interest in the ordinary savings market are practices that can threaten not only the liquidity but also the basic soundness of the commercial banking system.

A certificate of deposit is the issuance by a commercial bank of a receipt for funds deposited with the bank for a specific length of time and bearing a specific rate of interest. Negotiable certificates of deposit began to be promoted, very actively, 5 or 6 years ago by major New York City banks. Probably no one had any idea that these certificates would develop in such a short time to the tremendous volume that has resulted. Certainly no one would have thought 5 or 6 years ago that negotiable certificates of deposit held by corporations would have produced the kind of liquidity crisis in the New York money markets that developed last December.

In practice a negotiable certificate of deposit is very much like a Treasury bill, like the obligations issued by the various Federal agencies including the Federal Home Loan Bank System and the Federal National Mortgage Association. Certificates are very similar to commercial paper issued by finance companies and various corporations. In the space of a very short period of time negotiable certificates of deposit have developed into the second most important short-term money market instrument—exceeded in dollar volume only by short-term obligations of the U.S. Treasury.

The use of certificates of deposit in significant volume placed the banks, for the first time, in the contractual position of having to pay a certain rate of interest on obligations maturing on specific dates. While in fact demand deposits may be said to have 1-day maturities, the issuance of demand deposits, carefully handled, does not produce the recurring liquidity problems as can the issuance of I O U's with definite rates of interest and definite maturities. In contrast, the typical passbook savings business as practiced by the commercial banks and as practiced by thrift institutions, does not impose immediate and recurring liquidity problems as does the issuance of a large volume of certificates of deposit with contractual rates of interest and maturing on definite dates.

The payment of interest on large, short-term corporate deposits of this type and making loans with this kind of "hot money" has introduced a new element of vulnerability into the commercial banking business.

This element of vulnerability is simply that during a period of rising interest rates, there is mounting difficulty in "rolling over" maturing certificates of deposit. This element of vulnerability has been apparent to observers of the commercial banking business and to many bankers themselves. It also has been quite apparent to the Federal Reserve Board, and from time to time members of the Board of Governors expressed some concern about the potential liquidity problems which accompanied the buildup in negotiable certificates of deposit. On October 22, 1965, George Mitchell of the Federal Reserve Board declared in a speech in Chicago that the money behind certificates of deposit is the "most vulnerable" of all bank deposits because corporations and other holders of certificates are likely to respond quickly to

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relatively small increases in interest rates on other short-term certificates.

The vulnerability of the commercial banking business to changes in interest rates at a time when a large volume of certificates may be maturing was dramatically evidenced by the certificate of deposit crisis last December. With interest rates rising and with a large amount of negotiable certificates of deposit coming in the Federal Reserve Board boosted the maximum permissible ceilings on time deposits to 5½ percent. The Board has acknowledged that the increase in time deposit ceilings was essential if the commercial banks were to be able to renew approximately $3½ billion in negotiable certificates of deposit scheduled to mature in December.

The Board also admitted before the Joint Economic Committee of Congress that if the increase had not been granted, banks would have been forced to call many outstanding loans in order to meet these maturing certificates of deposit.

A number of things have concerned us about the events of last December. We believe, for example, that in view of the fact that the commercial banking business is $400 billion in size, the apparent inability of major banks in the United States to liquidate $3½ billion in maturing obligations should be a matter of proper concern for the Congress of the United States.

Another thing that has disturbed us is that despite the great certificate of deposit crisis of last December, nothing much seems to have been done to avoid a repetition of this crisis. On the contrary, the amount of negotiable certificates of deposit has increased from $16.3 billion in November 1965 to $17.4 on April 20, 1966. It is well known that several commercial banks in this country have failed in great part as the result of excessive and unwarranted use of certificates of deposit.

With short-term interest rates again pushing upward and with some of the largest commercial banks already paying 5½ on certificates of deposit, a question that must be faced is: What happens if interest rates continue to move up? Will some banks find even a 5½ rate inadequate to keep their certificates? Will the Federal Reserve Board find itself under renewed pressure to boost these ceilings even further in order to permit the major banks to secure renewals in the coming months?

We hope that during these hearings this committee will inquire into what the regulatory bank agencies are doing to police the issuance of certificates of deposit and what steps they are taking to avert another "CD crisis."

Again, I am not a specialist in central banking or in monetary policy, but it does occur to me that the widespread use of certificates of deposit might force the Board of Governors and the Open Market Committee to do certain things just to ease the banks through maturity periods—things that the Board of Governors would not otherwise want to do or have to do.

It also occurs to me that the hands of the Board of Governors should not be forced in certain directions as a result of excessive use of certificates of deposit.

We have the feeling in the savings and loan business that this is a new money market instrument the effects of which are not yet fully

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understood, that a new type of banking has developed to a point where it is far greater than anyone expected it to develop and we are concerned that deposit certificates, while viewed with some concern by the bank regulatory authorities, have not been subjected to any known controls.

Possibly the banking agencies have begun to enforce some informal and unwritten rules with respect to the use of the certificates—their amount in proportion to total deposits of the bank, the spacing of various maturities, and the payment of "bounties" of this money. However, we have seen no published guidelines or regulations and we fear this new phase of commercial banking is still largely an unregulated and unsupervised operation.

While the problem of negotiable certificates is an important one and deserving of thorough study, we believe that the spread of certificates of deposit into the savings market can be equally significant. The fact that the new time deposit ceilings of 5½ percent are being used extensively by commercial banks to recruit savings-type money—the kind that always has been in the passbook type of account in the commercial banks—may in the long run be substantially more important.

Many thousands of small banks in our country appear to be just as concerned as savings and loan people. The concern on the part of many small banks was reflected in the speech of the president of the American Bankers Association on January 31 in which he warned that the "unrealistic generous rates paid on certificates of deposit threaten to siphon funds out of smaller banks and, therefore, disrupt the flow of credit in many of the communities of the country."

The Federal Reserve has, in effect, lifted ceilings off of the savings market and opened the way for unrestrained competition in the savings market on the part of the commercial banks. The history is clear of what happened the last time we had competition of this type. The promotional-minded banks begin to pay unusually high rates and then in order to protect themselves, more conservative banks are forced to increase their rates to prevent their deposits from being siphoned away. Through this process, the price paid for savings money has skyrocketed even though the overall pool of savings may not have increased. Then to meet these higher costs, banks are forced to reach further and further for loans in order to secure the earnings and high interest rates to compensate for the higher deposit costs.

We believe that the Board of Governors wanted to avoid rate wars in connection with savings of the kind that has been lodged in commercial bank savings deposits and in the savings accounts of our institutions. On December 8 of last year in discussing the increase in the discount rate and the increase in the time deposit ceiling, the Chairman of the Federal Reserve Board made the following statement:

> The Board of Governors has purposely refrained from raising the maximum rate for savings deposits. It has done so in order to minimize the impact on competitive relationships between commercial banks and savings banks and savings and loan associations, which depend for their resources mainly on funds deposited by individual savers rather than by corporations.

This suggests that the Federal Reserve Board intended that the new time deposit ceilings of 5½ percent not be used extensively to recruit savings-type money. We expressed the view at that time that

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regardless of this statement of intent, unless the Federal Reserve took some action to restrict the use of the new time deposit ceilings to very large denomination amounts, it was inevitable that the new rates would be used extensively for savings money.

The action of the Board of Governors in permitting the 5½-percent rate on CD's may have been necessary to prevent the major corporations and investors from withdrawing massive sums from CD's on maturity dates. The manner in which this problem was solved, however, has created a whole set of new problems.

In spite of the December optimism that relatively few banks would raise rates and only in modest increments, and that other savings institutions would not be materially affected, we find the following actual developments:

(1) Large numbers of banks have increased their interest rates substantially with aggressive promotion.

(2) The certificate of deposit has been made to resemble an ordinary savings account by reducing the required deposit to $1,000, $100, or even less; by shortening the maturity, and by providing for automatic renewal.

(3) The adverse effect on the flow of savings into savings and loan associations and savings banks has been severe and the situation is worsening monthly. Those commercial banks unable or unwilling to compete at the new rates are equally affected.

It is pointless to debate where the fault lies and it is not our intention to dwell on who, why, or what caused things to go astray. We just recommend that everyone involved recognize the facts as they now exist and proceed to take steps that will restore balance and prevent a recurrence of the problems of last December.

At the time of the change in regulation Q last December, the United States Saving & Loan League and others predicted that the result would be an acute tightening in mortgage credit. We are rapidly arriving at this point. As this committee knows, the great bulk of funds for home mortgage lending comes from two types of institutions primarily—savings and loan associations and savings banks. Savings and loan associations located in communities throughout the country traditionally have provided from 40 to 50 percent of all the funds for home mortgage lending. Mortgage interest rates do not fluctuate widely as do the rates on Government bonds and short-term loans. For many of our institutions, rates in the range of 5 to 6 percent are charged year in and year out regardless of conditions in the money market. Beyond this, many State laws prohibit charging more than 6 percent or sometimes 7 percent for a mortgage loan on a home. Rates beyond this under many State laws are usurious.

The earnings of savings and loan associations today and our ability to pay high rates of interest for funds of the public are limited by the fact that our money is invested in mortgage loans made when interest rates were lower—last year, 2 years ago, 5 years ago, or 10 years ago. The earnings from a long-term portfolio of mortgage loans do not increase very rapidly when money tightens and interest rates go up in the money market. It is partly to provide some offset to this inflexibility that the United States League has submitted to your Housing Subcommittee legislation that would permit savings and loan as-

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sociations to make limited investments in loans on household furnishings and loans on mobile homes.

The commercial banks, as short-term lenders with their funds invested in short-term business loans and high-interest-rate consumer loans, are able to charge more in periods of high interest rates, and commercial bank loans can be adjusted to higher interest rates more readily. Bank earnings, thus, can increase very rapidly in periods of rising short-term interest rates and they can pay higher rates on savings.

In many instances today, commercial banks can afford to pay interest rates of 5 and 5½ percent for the savings of the public much more easily than can savings and loan associations and savings banks.

In great part because the commercial banks are bidding actively for savings funds at rates beyond those which can be paid by institutions investing in mortgage loans—and trying to provide economical home financing as is our mandate from Congress—today we are not attracting savings funds for mortgage lending in a satisfactory volume. The first 3 months of this year our net increase in savings was about $1,300 million compared to $1,900 million last year and as high as $3 billion in the first quarter of 1963.

Adverse savings flows, together with new restrictions on the availability of Federal home loan bank funds for mortgage lending and some decrease in loan repayments, suggests that in the last 8 months of this year our institutions will do well to make $11 billion in mortgage loans compared to $17 billion in mortgage loans in the last 8 months of 1956. At $20,000 per loan, the $6 billion drop represents 300,000 home loans that will not be made during the remainder of this year, as compared to loan value last year.

This will mean for the year as a whole an overall loan volume of $18 billion as compared to a volume of $23.9 billion during 1965. The 1966 loan volume represents a huge sum of course, and means that savings and loan associations will be continuing a substantial participation in the mortgage market.

Nevertheless, the lending capacity of the business will fall far short of the demands of American home buyers. This means more and more careful screening of borrowers. If you are a superb credit risk, credit will be available; however, many American families who would ordinarily qualify for mortgage loans will probably not make the grade in 1966.

Not all of this decline in the availability of funds for mortgage lending is due to the very aggressive promotion by commercial banks of 5 percent CD's packaged in denominations for easy sale to the public and in a manner designed to attract money of the kind that typically goes into passbook savings accounts. We are, naturally, suffering from the inflation psychology that is in the air, and that is stimulating some spending and some speculation.

At this point let me make it perfectly clear that a loss in savings, or a reduction in the growth of savings, does not per se have any adverse effect on the financial condition of our business. Financial institutions go into default because of bad loans and investments, not because people withdraw savings. The savings and loan business today is in a strong, safe, financial condition. The ratio of our reserves to our savings is increasing; loan delinquencies and foreclosures are dropping;

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appraisal practices have been tightened; and associations are maintaining much more complete records on the condition of their loan portfolios. Furthermore, as a result of legislation enacted in 1961, the reserve ratio of the Federal Savings and Loan Insurance Corporation has more than doubled in 5 years. The Corporation has far greater funds, absolutely and relatively, than ever before. The tiny number of savings and loans and other financial institutions which have been in difficulty has, of course, been well publicized. But there are over 6,000 strongly, well-managed savings and loan associations doing business. In short, there is nothing in the picture to cause concern to the American saver. It is the home buyer who faces problems.

While savings and loan associations have been forced to reduce their mortgage lending, the fact remains that we have been more actively in the mortgage market longer this year than other lenders. The commercial banks that made such great promises a few years ago about getting into the mortgage loan field have, in fact, virtually ignored it in the past year.

The commercial banker never has been very enthusiastic about making mortgage loans and he certainly does not make mortgage loans when there is a large demand for short-term, high-interest-rate loans from business and then the bank can put more and more money into loans on automobiles.

A severe drought in mortgage funds will very definitely reduce the volume of homebuilding the latter part of this year. We think that not only will there be a great reduction in the volume of loans for homebuilding, but there will even be a shortage of money for the purchase of existing homes.

In all frankness, it has appeared to me that the policies of the banking authorities in letting the certificate of deposit business at the banks grow bigger and bigger and spread throughout the banking community seem to ignore completely the welfare of specialized savings institutions and the vital role of these institutions in providing a steady flow of home mortgage credit. There must be an understanding of the fact that the typical buyer of a home and the typical homebuilder generally has weaker credit and fewer opportunities to borrow money than corporations and the sponsors of large apartment projects.

Savings and loan associations were created to assure a steady source of credit for typical families for whom homeownership is a dream and, we hope, a realizable dream. The country needs a type of institution where home buyers can go and have their needs taken care of in a convenient manner, where interest rates are not excessive, by people who understand the home mortgage loan transaction; a place where typical home buyers can go and not have to compete for money against big corporations and business borrowers.

While we share the concern of many about the practice of commercial banks in the issuance of large negotiable certificates of deposit, our main problem is the effect on the typical home buyer arising from the practice of commercial banks using the certificate device to attract the small savers and the money that typically has gone into passbook accounts in banks and savings and loan associations. This relatively new development in the growth of savings certificates obviously was not anticipated when certificates of deposit first de-

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veloped a few years ago and it obviously was not anticipated last December when the Federal Reserve permitted the commercial banks to pay as high as 5½ percent on CD's.

Instead of the typical $50,000 or $100,000 certificates negotiated with a corporation, these new certificates are now aimed at the passbook savings market. Their increasing use "runs around the end" of the Federal Reserve's prudent decision not to raise the ceiling on ordinary savings. Banks are promoting these new certificates with full page ads, with maturities as short as 90 days, and with minimum amounts as low as a few dollars. Even those with $1,000 or $2,500 minimums are exactly in the bracket that constitutes the heart of our savings funds.

This use of certificates of deposit for ordinary savings was not predicted by the Federal Reserve. In fact, the Federal Reserve Board has publicly cautioned the banks against this disruptive competition. So has the Federal Deposit Insurance Corporation. The hectic competition has also been criticized by many leading bankers. But it continues.

As a minimum program of action, we make the following recommendations to this committee—I emphasize this is a minimum:

(1) Certificates of deposit must have a single maturity. It is the practice now to allow the saver to sign up for one maturity and then permit him to take a shorter maturity at a lower rate. This, in effect, gives him the best of all worlds.

The fixed maturity would emphasize that a certificate of deposit is a distinct banking instrument and not an ordinary savings account.

(2) The practice of automatic renewals of certificates of deposit be eliminated. The automatic renewable feature makes this certificate more closely resemble ordinary savings. It puts the bank in a bind, committing it for a given rate over a longer period of time. It also contributes to some very misleading advertising.

(3) Amend the banking laws to prohibit misleading advertising and provide the Federal Reserve, the FDIC, and the Comptroller of the Currency with specific authority to require that advertisements carry a true story of the services being offered. I believe the committee has in its files numerous examples of ads featuring "25-percent interest" which is, of course, for a 5-year period. It is very confusing because interest rates traditionally are expressed on an annual basis. We would expect that with appropriate encouragement from this committee the banking agencies could eliminate most of these abuses without new laws.

If these relatively minor changes can be made, the certificate of deposit will resume more of its traditional function and there will be much less disturbance in the savings market. At the same time, it would not be such a precipitous change as to inject new problems for commercial banks. We do not consider these as antibanking suggestions. We feel they are consistent with the recent and urgent pleas for moderation in banking called for by Mr. Archie Davis, the president of the American Bankers Association.

Unless something is done to ease this hectic rate war, savings and loan associations face retrenchment in home lending which could trigger a major recession in housing.

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In conclusion, let me say that the savings and loan business of over $130 billion in assets—I suspect it is a little less after the month of April—is and will continue to be, a vital segment of the financial community, and an important factor in the national economy. Our leaders are responsible men. We fully recognize that the savings and loan business does not operate in a vacuum; that it must conform to national policy; that it must be subordinated to national needs. We are not against competition for savings and mortgages. Our concern is that the chain of events may have led to "over reaction" and that the pinch applied to the housing market may be unintendedly severe.

We appreciate this opportunity to present our views and we are confident that this committee will approve appropriate and constructive legislation.

The CHAIRMAN. Thank you, Mr. Strunk.

Now, if it is all right with the members of the committee, we will hear the representative of the other savings and loan associations and interrogate the two together.

So without objection, you may proceed, Mr. Sherbourne. You may identify yourself for the record and also identify the gentlemen who are accompanying you.

STATEMENT OF EVERETT C. SHERBOURNE, PRESIDENT, CITY FEDERAL SAVINGS & LOAN ASSOCIATION, WHIPPANY, N.J.; ACCOMPANIED BY WILLIAM J. KERWIN, ASSISTANT EXECUTIVE DIRECTOR, AND WILLIAM F. McKENNA, GENERAL COUNSEL, NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS

Mr. SHERBOURNE. My name is Everett C. Sherbourne and I am president of the City Federal Savings & Loan Association of Whippany, N.J., with 10 offices in 3 adjoining counties.

I have with me here Mr. William J. Kerwin, assistant executive director of the National League of Insured Savings Associations and Mr. William F. McKenna, general counsel of that organization.

Mr. Chairman, I want to express the appreciation of the National League for this opportunity to appear before this distinguished committee of the Congress. In the past, you have done much to develop the Nation's system of private financial institutions and, in particular, the thrift and home financing industry of the Nation. I would also like to commend the committee for this current series of hearings which we hope will lead to legislation that will halt the widespread misuse by commercial banks of negotiable certificates of deposit and other time deposit instruments.

The carte blanche given commercial banks by the Federal Reserve Board over the last several years to buy money from every conceivable source at ever-increasing interest rates—climaxed by the increase in the permissible rate ceiling on time deposits to 5.5 percent last December—has already caused unduly harsh effects on savings associations and the housing and mortgage markets of this country. To permit continued uncontrolled use of these destabilizing money instruments by commercial banks with the encouragement of the Federal Reserve Board will, unless checked by legislation, result in a chaotic

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impact upon the Nation's thrift institutions and the entire housing market.

The wisdom of your committee's consideration of this subject at this time and the severe and rapid changes that are occurring in the savings and housing markets as a result of the December change in regulation Q is confirmed by the fact that although the Federal Reserve Board itself just released a survey of post-December rate adjustments made by commercial banks, it announced this morning a new survey because "the market for savings has been undergoing rapid change in recent months." I can testify that is certainly the case in the State of New Jersey. It may be more than coincidence that the new survey announced today reaches the news media at the same time that this committee begins its hearings.

The volume of negotiable certificates of deposit has grown, with the consent of the Federal Reserve Board, from a negligible amount in 1961 to the enormous sum of over $17.5 billion. The use of this instrument to purchase bank deposits of short duration at high rates has caused continuous liquidity crises in the commercial banking system almost every 3 months because of the maturity concentrations in the quarterly periods in which corporations pay dividends and taxes. There appears to be little doubt that the volume of outstanding negotiable certificates of deposit constitutes a money market force which the Federal Reserve Board is unable to cope with except by increasing the rates banks may pay for these deposits. An analysis of the Board vote in December on the discount rate increase indicated that with one exception even those members voting against the discount rate increase voted in favor of increasing regulation Q from 4.5 to 5.5 percent. The volume of maturing December negotiable certificates of deposit and the liquidity crises facing the banks using them apparently left the Reserve Board with no other choice. That is a statement made to me by presidents of banks in New Jersey.

This situation was again repeated in March and April of this year according to the financial journals, and as a result many banks, spearheaded by the largest banks in the country, went to the 5.5-percent maximum.

The December action of the Federal Reserve Board not only permitted banks to boost their rates sharply on time deposits and certificates of deposit but also greatly shortened the time period in which such a deposit would be eligible for the new higher rates. Prior to December 6, banks were authorized to pay up to 4 percent for time deposits and certificates of 30 to 90 days and 4.5 percent on those of 90 days or more. The December order, however, increased the rate ceiling to a flat 5.5 percent and permitted this rate on any time deposit or certificate with a maturity of 30 days or more. Thus, time deposits by the Board's action came exceedingly close to becoming demand deposits. The pervasive influence of high interest rate and short duration spread to nonnegotiable deposit instruments such as savings certificates, savings bonds, and these are now being offered to the public by banks in most of the larger metropolitan areas of the country.

Comparisons of the composition of the increase in time deposits of weekly reporting member banks for the first 4 months of 1964, 1965, and the current year illustrates dramatically the Federal Reserve Board statement in its press release today that "the market for savings has been undergoing rapid change in recent months."

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This table summarizes the composition of the increase in time deposits in the first 4 months of each year for the years 1964, 1965, and 1966:

Time deposits of weekly reporting member banks—Individuals, partnerships, and corporations

[Dollar amounts in billions]

Year	Increase	Negotiable CD's		Other time deposits	
		Amount	Percent	Amount	Percent
1964	$1.640	$1.441	87.9	$0.199	12.1
1965	2.626	2.158	82.2	.468	17.8
1966	4.760	1.405	29.5	3.355	70.5

There are two substantive matters involved in this committee's current consideration of the Federal Reserve Board's administration of regulation Q and the annual increases in permissible interest rate ceilings paid on time deposits which the Board has authorized in each of the last 4 years. One deals directly with the liquidity of the banking system arising from the concentration of huge volumes of time deposits in ever-shortening maturities at the same time that bank loan-deposit ratios approach or surpass alltime highs.

The second is the unduly severe and potentially chaotic impact these Board-authorized increases in interest rates have on savings institutions and the residential housing market.

The effect of these developments upon savings institutions and housing markets is not an exercise in theoretical possibilities; they exist right now. I attended a meeting in Atlantic City a few days ago and the possibility in July of withdrawals that may be created by the CD market is one which is causing such great concern that the institutions find it difficult to determine what their lending programs can be for the next 6 months or even for that matter, for the next 3 months.

Both savings and loan associations and savings banks experienced substantial losses in savings last month. These losses are not being recouped. And further substantial reductions in existing savings held by these institutions accompanied by massive distortions in housing credit are a certainty unless some relief is given by this committee and the Congress.

In my own institution, in December, we were making some loans at 5.25 percent, a substantial portion at 5.5 and an equally substantial proportion at 5.75 and some at 6. Our institution has about $137 million in assets and is the second largest savings and loan association in the State.

In the last 3 months we raised the rates progressively with the hope of cutting down on the volume of loans, the ever-increasing number of loan applications that we were receiving and at the present time we are at 6 percent flat. Never in the entire 25 years that I have been in this institution have we had such a rapid rate of increase in such a short period of time.

Funds available for residential mortgage lending are the tightest in the history of my long association with the savings and loan business. Mortgage interest rates have risen abruptly as a result of the high interest rates authorized by the Federal Reserve Board, and in

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my judgment will go even higher. The raid on existing savings balances held by savings institutions resulting from the rechanneling of savings funds to the commercial banks has forced most savings and loan associations to reduce sharply forward loan commitments and marshal their resources to combat an unknown and imprudent and unsound spiraling interest rate competition for a limited supply of savings funds.

The Federal Reserve Board's policy of increasing interest rates has not produced additional savings. Net additions to savings in savings and loan associations, savings banks, and commercial banks are less for the first quarter of this year than any similar period since 1961. They should have had reason to anticipate this would result because of the economic markets and economic authority that the interest rate does not have much of an effect upon the increase in additional savings. While it is recognized that the demand for credit accommodations in many sectors of the economy is strong, such demand does not warrant a deliberate policy designed to prevent savings institutions from competing for new savings or even holding balances they already have.

The savings and loan business provides a unique service to the American public—encouraging thrift in order to provide funds on a long-term basis for housing our citizens. We are proud of our contributions to the American people, the American economy, and the American way of life. We have done this with small institutions of less than $50 million. By necessity, our mortgage loans are long-term extending over 20- and 30-year periods so that the average citizen can enjoy the benefits of homeownership when he needs the space to raise his family. Our mortgage portfolios turn over slowly, and we cannot adjust earnings rapidly enough to meet the interest rate competition from commercial banks that enjoy lower money costs principally because they do not pay anything for demand deposits, nor are we able to compete with them because we can't issue that kind of instrument. Savings and loan associations are vitally interested in stable and rewarding dividends to all savers as well as stable mortgage interest rates to homebuyers. We have a great respect for the competitive American economy and free enterprise, since we are dedicated to providing two of its major bulwarks. However, we do not believe that the rewards for our services should take the form of an abandoned ship buffeted by the churning, uncontrolled, high-interest-rate waves produced by the money managers.

I have a great deal of respect for the manner in which the Federal Reserve Board has throughout the past 5 or 6 years exercised control over the money market to give us a progressive and sound economy. But frankly, I am astounded at this particular development and in all frankness, when it was issued I didn't have any reason to anticipate the results here today and the problem is one that requires early action.

During the last period of "tight money" in 1959 it is interesting to note that the Federal Reserve Board did not change the interest rates commercial banks could pay on savings deposits. From January 1, 1957, to January 1, 1962, permissible interest rate ceilings under regulation Q were 3 percent for savings deposits and 3 percent for time deposits of 6 months or more, 2.5 percent for deposits of 90 days to 6 months, and 1 percent for deposits of 30 to 89 days. Evidently, the

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Board believed then that there was no economic sense in changing regulation Q to permit an unsound competitive interest rate war for the then limited supply of savings.

Since 1962, however, the policy pursued by the Board via regulation Q has changed considerably. Permissive interest rates have been adjusted upward four times. Moreover, the period of time a deposit had to be held to qualify for higher rates was progressively shortened. The distinction between 30-day money and term money of 6 months and longer disappeared, and it would appear that the Board consistently condoned and furthered the concept that money of any duration was suitable to support a banking business that was constantly making longer term loans and investments. As late as November 23, 1964, time deposits of 30 to 89 days were limited to an interest rate of 1 percent. Now, such short deposits can be paid 5.5 percent. It would appear that these changes in the regulation were directly related to the growth in negotiable certificates of deposit. Rates were consistently increased to permit the volume of these certificates to increase. As the volume grew, the liquidity exposure increased. Now, the unstabilizing effects of this policy by the Board have spread to almost all forms of nonnegotiable time deposits as well.

Until the rate change of last December, most of the four upward rate adjustments in regulation Q were attributed to adjustments required by our international balance-of-payments position; i.e., to maintain interest rate levels which would keep domestic funds at home and attract foreign investments. Nonetheless, commercial banks increased their foreign loans and investments $1 billion in each of the years 1961–63, and in 1964, the year in which regulation Q was changed to permit banks to increase interest rates from 1 to 4 percent on 30- to 89-day deposits, and from 4 to 4.5 percent on over-90-day time deposits, the banks increased foreign loans and investments by $2.4 billion. The logic of increasing interest rates payable on time deposits domestically for the stated purpose of curtailing the flight of funds abroad, and then to have that money channeled into the commercial banking system which proceeded to lend it in the very same foreign markets is contradictory on its face.

The record of the Federal Reserve Board's administration of regulation Q speaks for itself. The essence of the discretionary authority vested in the Board by the Congress is the maintenance of a sound banking system and the prevention of uncontrollable upward, spiraling interest rates whose inevitable aftermath is distorted and chaotic credit markets and massive dislocations in housing and other major industries.

During the last several years, the savings and loan business has been the subject of tight regulation by the Federal Home Loan Bank Board. Among these restrictions is a Board ruling adopted August 16, 1964, sharply restricting the use of certificates of deposit by savings institutions for liquidity purposes, an indication of the concern that has developed in Government over the CD instrument.

The Congress now has the opportunity to act to prevent further misuse of regulation Q. We would urge that consideration be given to a redefinition of a "time deposit" to give recognition to the fact that "demand" and "time" deposits are different and require a time differential of more than 30 days. A 6- to 9-month differential would

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be desirable. The issuance of "savings bonds" or "savings certificates" at rates higher than the rate ceiling on savings accounts should be terminated.

Finally, the National League would urge this committee to take whatever action is necessary to prevent regulation Q from being used to create chaotic destructive competition in the Nation's money markets and the accompanying adverse impact on home financing operations.

We also believe that the CD problem is just one facet of a competitive struggle between banks on one side and financial intermediaries such as thrift institutions on the other. We observe that commercial banks have been recipients of many favorable actions by Government agencies and Congress to facilitate their growth and development in recent years, while similar treatment has not been accorded the financial intermediaries. We believe this committee could render a major service by a well-considered study of competition between various financial institutions and ways in which these institutions—both banks and thrift institutions—can broaden their services to the American people.

Thank you.

The CHAIRMAN. Thank you very much.

You gentlemen have each given us a good paper on the subject and we thank you very much. It has been very helpful to our committee.

The basic trends behind the CD from the commercial bank standpoint are not fully discussed by either one of you in your statements before the committee. I just have been wondering whether or not, under the law, they are permissible for commercial banks. Commercial banks, of course, have a great privilege—they have the exclusive sole privilege of accepting deposits for checking account purposes.

No other financial institution may offer checking accounts. They have an exclusive in that respect, which gives them a great advantage. It is a wonderful opportunity for them to create goodwill for themselves, and they take full advantage of it, as they should.

But if a person were to go to the Comptroller of the Currency and ask for a charter for a new bank on the representation that he wanted to establish a bank in a town that is already well supplied with banks, the Comptroller of the Currency would probably say, well, now, we usually establish banks where there is a need, a demand for services for banks that are not being filled at the present time. And, where are you going to get your deposits? These other banks seem to take care of all of the deposit needs of the people in the community and this person who is an applicant for the charter would state, well, we will get our money by outbidding other people all over the Nation, New York, Chicago, Detroit, Dallas, and elsewhere, and we will run our bank by outbidding all others. I do not think that would be a very good reason for a charter and I am sure that the application would be turned down.

In this particular case that we are discussing, we find a similar or comparable situation. But, although they are not using this as a reason or argument to get a new charter, they are using the establishment, having been created already, the charter issued, for just that same purpose. I just do not believe it was ever contemplated or intended under the law that CD's would be used by commercial banks

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in that way, and I think the committee would be interested in a good legal presentation along that line, and if you gentlemen, representing the savings and loan industry, which we are all very proud of, over $120 billion, and one of the greatest financial institutions in our country—if you would prepare such a paper and give legal arguments, I think our committee would like to see it.

Would you give some consideration to that, Mr. Sherbourne and Mr. Strunk?

Mr. STRUNK. Yes, sir; that is a very good idea. That particular line of approach has not been considered by us.

The CHAIRMAN. The way I see this, this is a critical time. In 1932 I was here when banks would not encourage homebuilding. Their terms were too particular and interest rates too high. And Mr. Hoover at that time, representing his party, now the minority party, he thought it was so serious, he asked for passage of the Federal Home Loan Bank Act which caused the creation of all these Federal savings and loan associations. Before that time they were referred to as homebuilding associations, and building and loans and many other different kinds of names, but this concentrated the name in one phrase, savings and loan associations.

Now, since that time, you people in that business have done a wonderful job, just a wonderful job. You take California, for instance, it has become the State with the greatest population of any State in the Union, I think solely because of home construction in a State which was provided by the savings and loans. So I look with great disfavor on anything that is done that would retard the savings and loan associations, because they have done such a wonderful job and because they have been built up by necessity.

We just had to have them. Now, then, the banks—we need banks—they are wonderful—we are greatly obligated and entitled to them for the very fine service they have rendered in time of war and in time of peace. We are not trying to destroy the banks. We want them to move ahead. But I, personally, feel that there is a place in our economy for both the savings and loans, the thrift institutions, and the commercial banks, without one being permitted to destroy the other. If I am any judge of this, if this goes on, something has got to give. Both of them will not go indefinitely this way. I do not see how they could do it. I am going to do my best to try and find out the answer. We have no prior commitments about it. We do not know enough about it at this time, but we know there should be an answer. I am going to try to find it in these hearings.

Mr. Ashley?

Mr. ASHLEY. To what extent, in your opinion, are certificates of deposit responsible for the rising interest rates that we find throughout our financial structure?

Mr. SHERBOURNE. The table that I read during the course of my remarks indicated the extent to which the competition from these high rate CD's has caused a tremendous increase in the time deposits of commercial banks. You remember, the rates reversed themselves and the major part of the increase in the last 4 months was other than negotiable CD's.

Now, that money came largely from savings and loan associations and savings banks. I mentioned that at this convention I attended.

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There was one manager after another who spoke about tracing $50,000 and $100,000 deposits that a particular bank absorbed, which happens to be concentrated on advertising the high rate on these certificates of deposit. It has been a major factor in the distortion of the savings trends in the last 3 or 4 months.

Mr. ASHLEY. Is the impact of CD's on the savings and loan industry measurable?

First of all, can you tell the extent to which depositors, shareholders, as the case may be, might be withdrawing funds for deposit in return for CD's in commercial banks and to what extent do savings and loans themselves make use of CD's? To what extent do they put their funds into commercial banks in return for certificates of deposit?

Mr. STRUNK. Mr. Congressman, we have some of our institutions that place their liquid funds in commercial bank CD's in preference to buying Treasury bills, for example. I don't have any dollar figures on that, but it is fairly small. Now, the effect of all this commercial CD competition—I think this is fairly well measured by the savings flows we had in the last 3 or 4 months—by the flows of savings in and out of our institutions. We are taking in less than we are paying out in withdrawals, more. In the first 3 months of 1965, we had a net gain in savings of $1.9 billion and in the first 3 months of this year, a net gain of $1.3 billion.

Mr. ASHLEY. 1.9 in 1965?

Mr. STRUNK. Yes, sir; in the first 3 months. In the month of April, when this really hit us, in April of last year we had a net decrease in savings of $94 million. This year, in April we have a net decrease in savings in excess of $500 million. We don't have any final figures yet.

Now, about half of our associations pay their dividends quarterly and the other half pay them semiannually. Those that are paid in quarterly were not in the red in April, so this $500 million net savings loss in the month of April was felt by about half of our institutions, half in terms of dollar volume and we are looking forward to what we call a very red July unless something happens, when all of our institutions will pay a dividend and when all of our business will be subjected to the full brunt of high rate commercial bank CD competition.

As a result of these savings losses by half of our business in April, as a result of all the concern about July, and as a result of a lesser gain in savings in the first 3 months of this year, we are substantially reducing our loan commitments and volume of loans that we can make. There will be quite a bit of lending going on in the next several months because we have a lot of loans in the pipeline. But our people are putting nothing new in the pipeline, which means you are going to get a drastic reduction in the amount of loans, not only for homebuilding, but also for home buying, because our people don't know how to make any commitments as to funds available in the next 4 or 5 months.

The most important thing for us, of course, is to keep meeting withdrawal requests. If we have major demands on our institutions in July, we will honor those demands and we will honor loan commitments that have been made. But we are being a little leery about making future commitments in the face of a very dismal savings picture.

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Mr. STEPHENS. Would the gentleman yield? I would like to ask you this question. Is it not true that the Federal Home Loan Bank Board has directed the boards in the regions not to make any loans before taking a careful look at commitments after that date?

Mr. STRUNK. Yes, sir.

Mr. STEPHENS. Am I correct in that?

Mr. STRUNK. You are absolutely correct and this, again, has produced major changes in the attitudes of our people with respect to the kinds of loans they are willing to commit—now we will be able to commit for loans only amounts in relation to savings flows and loan repayments and we are, frankly, quite pessimistic about that. Whenever a lender is pessimistic about his sources of cash, you can be sure he tightens up on his loans.

You asked about the effect on interest rates——

The CHAIRMAN. Will the gentleman yield for one suggestion, Mr. Ashley?

In this morning's New York Times, Monday, May 9, 1966, on the front page there is an article, "Savings Accounts Fall by $1 Billion. Survey Points to Shortage of Home Building Credit." April was the "Worst Month in History."

I ask unanimous consent to put this in the record at this point.

Mr. ASHLEY. Could it be following this? He is right in the middle of a sentence.

The CHAIRMAN. At the end of your time. Without objection, so ordered.

Mr. STRUNK. Whenever lenders are short of funds, they tighten up.

Mr. ASHLEY. Obviously, the increased use of CD's is a factor in the increasing cost of money. What you have been discussing is the dismal picture that confronts your industry with respect to decrease in amounts of savings; is that not so? This is not totally attributable to the increasing use of certificates of deposit—the action taken by the Federal Reserve Board with respect to increase of rediscount rates is a factor, and any number of factors that contribute to this picture; is that not correct?

Mr. SHERBOURNE. Well, Congressman, I think the primary impact comes from these high-rate CD's. The level at 5½ percent, many of us began to ask the question, which they didn't answer, is that what the Board thinks is a permissible money rate? Is it what it should be? Will the banks go up to it? Well, gradually they did.

Let me cite what happens and why we believe the impact of CD's is primarily responsible for the substantial withdrawal and which has cut down our net increase to a point where we are no longer able to take care of the mortgage volume that has been coming to our doors.

Most of our customers are plagued—are attracted by these advertisements that state that you can get a CD for 3 months, or 6 months, or 9 months, with a rate of 5¼ percent, and if you withdraw within that period, perhaps on not more than 30 days' notice, sometimes no notice at all, you will get a basic rate of 4 percent—somewhat under what we are paying as a current rate on all our savings.

Now, actually, you can see this is going to be very attractive because the most that they stand to lose is perhaps, a quarter of a percent, but they may gain as much as 1 percent if they last and stay in for the full 30-, 60-, or 90-day periods and since most of our savings

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and loan savers are long-term savers, they are not concerned with having to withdraw before this time.

I cited to you earlier the increase in time deposits during the first 4 months of 1964, and our customers would naturally go into a nonnegotiable certificate of deposit and not into a negotiable CD. They are not acquainted with that market anyway, too much. The increase in other time deposits where our money would go, if they went to a CD, was in the first 4 months of 1964, $199 million, and in the first 4 months of 1965, $468 million, and in the first 4 months of 1966, $3,055 million. The difference is so great that I submit, Congressman, it is reasonable proof of the statement we are making to you.

Mr. ASHLEY. Thank you very much.

(The article from the New York Times previously referred to follows:)

[From the New York Times, May 9, 1966]

SAVINGS ACCOUNTS FALL BY $1 BILLION—SURVEY POINTS TO SHORTAGE OF HOME-BUILDING CREDIT

(By H. Erich Heinemann)

An estimated decline of $1 billion in savings accounts at savings banks and savings and loan associations has accentuated the fear that a shortage of credit for homebuilding may develop during 1966, a survey of government and trade association economists indicated yesterday.

The billion-dollar outflow in April of savings accounts from such institutions compares with an outflow of only about one-tenth as much in April 1965.

The savings banks and savings and loan associations—often referred to collectively as the thrift industry—are the principal suppliers of funds for home mortgages.

WORST MONTH IN HISTORY

Official statistics will not be ready for several weeks, but on the basis of initial tabulations and estimates by usually well-informed economists, it seems likely that the thrift industry has just weathered its worst month in history.

The $1 billion drop was not taken by economic experts as any sign of lack of confidence in the thrift institutions, but rather as evidence—among several factors—of the impact of the upward spiral in interest rates that has gripped the economy in recent months.

Paradoxically, however, major commercial banks in big cities, which have been aggressive in bidding for individual savings recently, do not appear to have been particularly successful in improving their share of the savings market.

The commercial banks' gains in time deposits (on which interest rates of up to 5½ percent are allowed) have been just about offset by declines in their passbook savings deposits (on which commercial banks may not pay more than 4 percent).

A time deposit is one which the depositor agrees to leave with the bank for a fixed period. A savings deposit, on the other hand, can generally be withdrawn at any time on presentation of the passbook.

The April outflow from the thrift institutions appears to have spread widely through the economy: into purchases of corporate and tax-exempt municipal bonds, into purchases of Series E U.S. savings bonds (on which no taxes need be paid until they are finally cashed in), into the purchase of mutual funds, into stock market speculation and into the purchase of major appliances and other consumer durable goods.

For all its massive size, the national decline of $1 billion in savings accounts was heavily concentrated in two areas—the east and west coasts. Mutual savings banks in New York lost $301 million in savings accounts during April, and savings and loan associations in California are estimated to have recorded a net loss of $400 million in their savings accounts for the month.

And even within New York, the deposit decline has been localized. The 15 largest mutual savings banks in New York City lost $189 million during the month, for a total drop since March 29 (the first of 3 "grace days" at the end

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of the first quarter when deposits could be withdrawn without loss of earnings) of $312 million.

It seems highly unlikely that anything like this rate of decline will continue for long. Major mutual savings banks in New York City are expecting a fairly substantial net inflow of funds during May. And in California—where there has been something of a "crisis of confidence" because of widely publicized financial troubles at a few savings and loan associations—the forecast for May is for a net inflow of funds.

NOT A NORMAL OUTFLOW

There is no question but that the April outflow was far beyond anything that could be attributed to "normal" withdrawals to pay taxes or of accumulated earnings.

The April outflow was clearly the consequence of the broad escalation of interest rates that has occurred in the economy in recent months.

The thrift institutions, which get their income largely from investments in home mortgages, have been, in many cases, simply priced out of the market. Their mortgage portfolios turn over slowly, and when interest rates rise rapidly, as they have lately, the income of the savings banks and savings and loan associations cannot keep pace.

This, in turn, limits their ability to compete for funds with other, alternative opportunities for investment.

Federal regulatory agencies are considering changes in their policies that would allow savings and loan associations more freedom in raising dividend rates in order to meet competition. But it is lack of earnings, far more than regulatory shackles, that is likely to limit the actual dividend increases that take place.

Commercial banks, for their part, generally have far greater ability to adjust their lending rates to changing market conditions, and also to adjust the rates that they pay in order to attract the money that they lend.

The commercial banks have taken advantage of this flexibility, in some cases increasing the rates they pay on time deposits to 5½ percent, the highest now permitted by law. Very few savings banks pay more than 4½ percent, and 5 percent is generally the top rate at savings and loan associations, except for special, long-term accounts.

Yet it is a paradox of the present situation that the big-city commercial banks, which have been the most aggressive in raising rates in order to bring in new deposits, have not been particularly successful.

BIG LOSS FOR BANKS

During the crucial month of April, the 380-odd commercial banks that report figures to the Federal Reserve on a weekly basis—this includes the vast majority of banks with assets of more than $100 million—lost $1.7 billion in passbook savings accounts, which under the law may not yield more than 4 percent.

But in the same period, these same banks gained almost $1.9 billion in time deposits, which under the law may yield up to 5½ percent. Only $309 million of this $1.9 billion increase was in the form of the large-denomination ($100,000 and up) negotiable certificates of deposit that major money-market banks sell to large corporations.

To many observers, this juxtaposition of loss and gain is undeniable evidence that large commercial banks, at least, have simply been shifting deposits from 4 percent passbook savings accounts to time accounts yielding 5 percent or more.

Interestingly, smaller commercial banks seem to have been somewhat more successful in attracting funds than their big-city cousins. The Federal Reserve estimates that total time and savings deposits of all commercial banks increased about $2 billion during April, with about 60 percent of the increase coming in banks with assets of less than $100 million.

The chances are that the bulk of the small-bank increase has been generated in local communities, rather than being pulled, en masse, from competing thrift institutions.

But if major commercial banks are just barely breaking even in their quest for funds—and smaller ones aren't acting as a major force in the money market—then to whom, or to what, did the thrift institutions lose $1 billion during April?

There are no clear-cut answers, but it is likely that many factors are involved. Personal spending is high, and people are spending an exceptionally large proportion of their disposable income, while saving correspondingly less.

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For example, the Commerce Department figures that only 4.8 percent of after-tax income was saved during the first quarter, the lowest level since early 1963, and down from 5.6 percent in the last quarter of 1965.

Then, too, yields on corporate and municipal bonds are at historically high levels, and interest on U.S. Government savings bonds—on which income taxes can be deferred—has just been raised to 4.15 percent.

Beyond this, mutual fund sales—including the almost $400 million raised by the Manhattan Fund—have been soaring, and some of this money has come from savings banks and savings and loans.

All of these factors have undoubtedly combined to pull funds out of the thrift institutions, the traditional mainstay of finance for housing.

As C. A. Duncan, Jr., president of the United States Savings & Loan League, put it earlier this week, "The housing industry could become the 'Appalachia' of the American economy later this year."

The CHAIRMAN. Mr. Widnall?

Mr. WIDNALL. Thank you, Mr. Chairman.

Mr. Strunk, Mr. Sherbourne, we certainly welcome you before the committee today and I think you have made some very strong constructive suggestions as to how to handle certificates of deposit in the future. They unquestionably have had a very severe impact, not just on the whole building market, but on many of the other forms of activity within the economy. It behooves us to really understand what is going on, what is affected. The complete magnitude of it and what will eventually happen if allowed to go on in a similar manner in the future, unchallenged and without any form of direction by the Congress or any other agency of the Government, is something we are interested in.

I know that the builders are terribly bothered about existing money rates. Some conversations that I had over the weekend, they were worried about the fact that a lot of builders were going to go into bankruptcy one of these days. They said that it is not just a question of loans, the terms of loans, but they also have been affected more and more by unreasonableness on the part of communities with respect to restrictions on the builders as they come in to make their developments and require so many things of them that it is almost impossible to go ahead with a building program. I think it would be very, very wise for our own committee, the Subcommittee on Housing, to go into this as well as the effects of the CD which we are now doing through the full committee.

We had some testimony the other day on the participation sales program as contemplated for FNMA and Mr. Barr, who was testifying for the Treasury, stated that they now have $33 billion in Government-held assets. By the end of this year, if this program did not go through, he mentioned it would be $39 billion, and within a couple of years $50 billion, and then, a few years, later, about $100 billion. It is contemplated that if this program goes into effect, that $8 billion in Government-held assets would be sold through the trustee and issuing them through sales participation to buyers throughout the country.

What effect do you think FNMA extended activity in the participation sales at the 5½-percent yield rate, will have on your business?

Mr. SHERBOURNE. I don't know where the money is coming from to take care of all these demands and requirements. Because if they sell $8 billion, they are going to dry up that much more—that much in funds at a time when, as we are testifying here this morning, we have

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doubts, because of the CD competition, that our institutions can handle the volume of loan applications that are developing at the present time.

Mr. WIDNALL. Mr. Strunk, would you comment on that, please?

Mr. STRUNK. I have been concerned that these certificates will provide a new kind of competition for the savings of people, particularly if they package them and market them in units of $500 to $1,000. It can provide another kind of CD competition for thrift institutions. That is my major area of concern.

Mr. WIDNALL. Is it not true that the short-term Treasury's sometimes have had an impact?

Mr. STRUNK. Yes, sir; during, particularly, 1959, I believe, when the so-called magic fives were issued, our institutions didn't feel that as much as the savings banks did, but the savings bank people tell me that they had a lot of money withdrawn for investment into the so-called magic fives. Any time any kind of money market rate goes up and where people can buy them in convenient units, it has disrupted forces again in the savings market.

Mr. WIDNALL. Are you not bothered by the fact that a multibillion Federal long-term instrument such as FNMA's participations is above the 4¼-percent statutory bond limit and will, therefore, permanently take things in a direction that will be opposed to the building industry?

Mr. STRUNK. We are concerned about it, and hope it doesn't develop excessively.

Mr. WIDNALL. Thank you.

The CHAIRMAN. We want to go around first on the 5-minute rule. I feel that all members should have the privilege of asking all the questions they desire to ask about this and we are doing a lot of pioneering here.

It is an unexplored field and I think we ought to give them plenty of time. We will first take 5 minutes around.

Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman. I would like to ask you gentlemen, are there such things as nonnegotiable certificates of deposit?

Mr. STRUNK. Yes, sir; the typical certificate issued is a nonnegotiable CD.

Mr. MOORHEAD. What you are concerned about is the negotiable CD's? Is that correct?

Mr. STRUNK. We are concerned about both of them. The nonnegotiable CD is the one that has the most direct effect upon the savings and loan business, but the negotiable CD is a new money market instrument, and we are concerned about the effect of that upon banking in general, and the liquidity of the banking business in general. We are concerned that it will produce another kind of CD crisis such as we had last December. That was the crisis of negotiable CD's. But so far as we feel it in our institutions throughout the country, that is a problem of nonnegotiable CD's.

Mr. SHERBOURNE. Congressman, if I might add something to that point. I believe the reason that the rate was raised to 5½ percent and the reason that the banks have been coming out with nonnegotiable CD's in $25, $50, and $100 denominations is because the negotiable CD market became a problem to them.

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They anticipated that billions were maturing and the corporations would probably use them for expansion purposes, inasmuch as the tight money market was making it difficult for them to get the money they might need for the expansion programs. So, really, what is happening at this point, is that the nonnegotiable market is getting down to the level of the little saver and the billions produced thereby are taking care of the problem that is developing in the negotiable market.

Mr. MOORHEAD. The point that I am making is that H.R. 14026 only covers negotiable CD's. Is this sufficient in your judgment, or should the bill be broadened?

Mr. SHERBOURNE. In my own opinion, the bill might well be broadened.

But, may I say that when it comes to matters of this kind, this is the first time that I have ever testified in a matter relating to commercial bank practice. As an industry, we like to take care of our own problems and simply ask your powers from Congress. Where someone goes too far you do this to another type of institution—at this point, the negotiable CD market is, in the opinion of so many money market authorities, a problem that we can safely say regulate it. But if you want our additional opinion, it would be that you ought, at the same time, to redefine time deposits and redefine the amount of issuance for these nonnegotiable certificates, so that, in effect, you don't have a conflict within regulation Q, itself, where they say that the rate can be a certain amount on savings accounts, and they permit a nonnegotiable CD bearing a higher rate of interest to be issued in such small denominations that it is, in effect, another type of savings account.

We think that is an area that your committee ought to consider.

Mr. MOORHEAD. I would like to ask Mr. Strunk this: I notice on page 13 of your testimony, you give us three recommendations. Is it my understanding of your testimony that you would favor legislation that enacted these three things, rather than—or in place of H.R. 14026?

Mr. STRUNK. No, Mr. Congressman, we support H.R. 14026. We are really concerned about CD's and this would solve a problem. We would prefer the word "nonnegotiable" come out and the CD's in general be prohibited. This, certainly would solve the problem. If less sweeping measures are proposed, we would support them, too. In any case, we think that steps need to be taken to deal with the consumer CD's. These particular steps outlined in my testimony, we think, do not require legislation.

Mr. MOORHEAD. I see.

Mr. STRUNK. We would hope that the Board of Governors would put these into effect right away. If the Board of Governors doesn't, then, legislation could be enacted in this direction. These are minimum steps as against dealing with the problem head on, as does H.R. 14026.

Mr. MOORHEAD. Referring to page 12 of your testimony, you talk about the typical $50,000 or $100,000 certificates. Suppose we enacted legislation which put a floor on the CD's, let us say, $50,000 or $100,000. Would this either solve the problem or go a long way toward solving the problem?

Mr. STRUNK. It would make the savings and loan man very happy and go a long way to solving the problem of the savings market. It

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wouldn't necessarily solve the basic problem of this new instrument, but it would go a long way to solving the problem with respect to some flows of savings.

Mr. MOORHEAD. You use this term, "runs around the end" of the Federal Reserve's decision. It seems to me that it could be very well argued that where the CD is negotiable, or where you can turn it in without notice for a lower interest rate, that it is an end run around the provision prohibiting interest on demand deposits.

Mr. STRUNK. And an end run around the prohibition against paying more than 4 percent on the passbook accounts. These certificates are very much like a passbook account. The Federal Reserve wisely prohibited bank competition in that area, but the way the banks have used the certificates, they are getting passbook money into the higher rate savings certificates, savings bonds; the variety of new instruments that the bankers are creating.

Mr. SHERBOURNE. Congressman, I think you must note, too, that the small savings CD is not generally issued in commercial banks in our area. In most States, I believe, the CD, the negotiable CD's, are issued by one or two or half a dozen of the largest banks. They have not generally been used yet by the small banks—the small banks, by that, I mean $200 million, $100 million.

Mr. MOORHEAD. Thank you both very much.

The CHAIRMAN. Mr. Stephens.

Mr. STEPHENS. Thank you, Mr. Chairman. I would like to ask your opinion—both of you—of this: In 1961, when the liberalization was made of regulation Q, there was a billion dollars, estimated, to be in the certificates of deposit. About a year ago when the Banking and Currency Committee made a visit to Philadelphia, I think—a little over a year ago—I saw in the Wall Street Journal where the certificates of deposit amounted to $14 billion. Now, I have observed since that time that it is somewhere between $16 billion and $18 billion.

In a 5-year period, then, we have seen the deposits go from a billion to $17 billion. Now, all of that money had to come from somewhere. It has not come from savings and loans, where has it come from?

Mr. STRUNK. I think most of this money—it comes from corporations.

Mr. STEPHENS. Their earnings?

Mr. STRUNK. Their liquid funds. It may be retained earnings, it may be temporary proceeds of the sale of securities, it may be cash built up in anticipation of a dividend payment. These are liquid funds of corporations. Before the CD practice started, these funds were invested in Treasury bills, invested in obligations of the Federal Home Loan Bank System, intermediate credit banks and in commercial paper, and much of it used to be in checking accounts of commercial banks. The commercial banks have, in effect, developed a new money market instrument in competition with the U.S. Treasury and with the Federal agencies and with other corporations that issued commercial paper.

Mr. STEPHENS. In other words, I do not know whether it is still in effect now, but a corporation could not have a regular savings account. Has this been relaxed?

Mr. STRUNK. It may be a little bit to get around that. The corporation cannot invest in a passbook account in a commercial bank.

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Smaller corporations put money into our institutions, but savings institutions like ourselves, frankly, don't like to take large sums that may be quickly withdrawn. Savings institution people look with considerable concern when you get to $50,000 or $100,000 deposits. It is not our kind of money.

The negotiable CD started out with maturities of $500,000 and $1 million. This is short-term corporate liquidity. That is where the $15 billion, $16 billion buildup came. Since last December, we have a buildup in consumer CD's, as we call it, sold to people as against the corporate treasurer.

Mr. STEPHENS. That is where the squeeze has come in?

Mr. STRUNK. That is right; where it is happening to us. I am satisfied that the issuance of some $15 billion of competition for U.S. Treasury obligations had something to do with squeezing the U.S. Treasury a bit. You put $15 billion of something in the short-term money market in competition with short-term Treasury obligations and in competition with Federal home loan bank obligations and it increases the short-term interest rates just as now it is increasing interest rates in our field, which is increasing the cost to homebuyers. As Mr. Sherbourne said, we just don't have as much money for new loans. What we do is, instead of making 85-percent loans, we make 75- or 70-percent loans. When you have less money, you not only raise the rates, but stiffen your requirements considerably.

Mr. SHERBOURNE. Congressman, may I add one small fact to put this in focus? In 1961, when negotiable CD's first came out, the total amount of certificates of deposit—the total amount of time deposits, at that point, was something like $13 billion. In the intervening 6 years, the negotiable CD has gone from zero to about $17 billion, whereas, the other time deposits, the nonnegotiable type of instrument, has increased only $1 billion or $2 billion.

So that you see, therefore, the negotiable CD's are the instrument that is causing the problem today.

Mr. McKENNA. Mr. Congressman, may I respond to your particular question by reading, I would say, from a neutral witness in this case? I am reading from an article in the Banking Law Journal of November 1965, which you will note was before the increase in rate ceilings in December of that year.

The article is entitled "Time Deposit Banking" and it is by Herbert Prochnow, Jr., attorney, the First National Bank of Chicago.

On page 951, he said:

> In February of 1961 commercial banks, utilizing a longstanding provision of regulation Q, began to offer time certificates of deposit to their customers. At first, these certificates were for large denominations, $1 million or more, and carried maturities ranging between 6 months and 1 year.
>
> These certificates, issued in negotiable form, attracted corporate funds which could not be accepted as "savings deposits" under the provisions of regulation Q. Competitive pressures then forced the banks to issue certificates in smaller denominations and for varying maturities. A market for these negotiable certificates of deposit has developed so that they can be readily sold by the holder, prior to maturity.
>
> The growth of this market has been of great significance in making time deposits an attractive liquid asset to corporations and other large investors.
>
> Recently, banks have also been increasing quantity of nonnegotiable certificates of deposit to individual savers, who are willing to commit their funds for long periods of time in return for the somewhat higher rates which banks are willing to pay on nonnegotiable certificates. It is entirely possible that nonnego-

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tiable savings certificates will, in the years to come, drastically alter individual savings account relationships as negotiable certificates of deposit have already changed and greatly expanded corporate time deposits.

The CHAIRMAN. We are glad to have this information for the record.

You know, in 1960, the short-term interest rate was rather low. These huge corporate funds were in the market every week for short-term Government securities. I do not know who devised the plan or who was the author of it, but some person, I guess thought they could raise the interest rates on the short-term U.S. Government securities.

They wanted these short-term rates raised. Well, if they could get the CD's in a race, really, an inflationary race, as to rates, why, they would get their objective. They would get the short-term rate raised. So, these managers of huge corporate funds were induced to invest them in CD's at 3 and 4 percent. At that time it was a big windfall to them, a big bonus. It is much more than they could get on a short-term rate, and naturally they went there awfully fast. And in the next 6 years they went to over $17 billion. They went up very rapidly and left the short-term Government market entirely. That market started up and last December there was a crisis. You know, a lot of CD's were coming due and there was no way for the banks to renew them. They could not pay them enough interest. That was the crisis in December that caused the Federal Reserve Board to react and they had to do something and they had to do it fast. They could not increase their interest rates enough to let them keep these time deposits, these CD's, so that is the reason they increased the rate from 4 percent to 5½ percent, thus 37½ percent. If somebody else had raised prices 37½ percent, if a manufacturer of automobiles raised his rates, his prices, 37½ percent, he could not sell them. But they got by in raising those CD rates 37½ percent.

That was a race between the short-term securities, the rate there, and the CD's that got us into this inflationary condition, and it has caused all this trouble.

There was a hearing before the Joint Economic Committee, during the month of December, last year, to draw out all these points. It is not disputed that the reason they had to raise those rates so high was to take care of these few banks, and a relatively few of them, just a handful that had all these CD's outstanding against them. They were hurting and they had to do it. Anyone who is interested can call the Joint Economic Committee and ask them to give you a copy of that hearing for your purpose and you will get it, I guarantee you that.

Mr. Harvey?

Mr. HARVEY. Thank you, Mr. Chairman. Mr. Strunk, as I understand what you have been telling us, is that actually the savings and loans that have been living with CD's for a good long period of time—this is not new—and actually, you are not interested in getting corporate funds. What you are really interested in, is the abuse of these CD markets which has come about recently; is that correct?

Mr. STRUNK. Yes, sir; I would say that is correct. We have been living with CD's some time. We have been living with CD's since 1961, 1960, when they first developed in volume. The consumer CD's, that is. We have been living with them since then. I distinguish them between negotiable and nonnegotiable. I call the negotiable ones corporate CD's.

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Mr. HARVEY. What is the lowest limitation of the CD that savings and loans could live with? $5,000?

Mr. STRUNK. The higher, the better.

Mr. HARVEY. Obviously.

Mr. STRUNK. $15,000 to $20,000.

Mr. HARVEY. You are saying, $15,000 to $20,000. Could you supply the committee with any breakdown of information, for example, as to what percentage of the CD's that are issued today that are in the $15,000 to $20,000—what percentage are in the $15,000 to $20,000 bracket? This would be very useful information, I would think.

Mr. STRUNK. One handicap we have is that the FDIC and the Comptroller do not collect much information in this area. The Federal Reserve collects information about negotiable CD's. In December, the Fed sent out a questionnaire as to the practice in issuing CD's. The results were published in the Federal Reserve Bulletin in the month of April or May. The Fed has now announced a new survey of practice in the CD area and we would hope the information the Fed is getting now will tell us how much of the money is in CD's of, say, over $15,000 and how much of the money is in the CD's of under $15,000. My guess is that 90 percent of the money in CD's is in amounts—in $15,000 and over. The total dollars they are attracting in the smaller CD's is not significant in terms of banking resources.

But it is terribly significant in terms of shift of money out of the mortgage market. Do you follow me?

Mr. HARVEY. I follow you; yes. What you are saying is that 90 percent of the CD's consist of corporate money that you are not interested in—in the past anyway—but the 10 percent, the $15,000 to $20,000 is money that comes in by the shift. What you are further saying is that that complete information is not readily available at the present time?

Mr. STRUNK. It has never been available until the Fed made the December survey. I am not positive whether the Fed's December survey gives this information. I understand that the Fed's May survey probably will give this information.

Mr. HARVEY. On page 13 of your statement, you made several recommendations but you omitted a minimum limitation for CD's. Could I ask why, or your reason?

Mr. STRUNK. We were suggesting a minimum program that would not necessarily require legislation.

Mr. HARVEY. But you are telling the committee here, today, such legislation is wise; is that correct?

Mr. STRUNK. It will be very, very helpful. I would say it would be wise; yes, sir.

Mr. SHERBOURNE. May I add something to why we are being affected today and we weren't back 6 or 7 months ago? It was the practice of commercial banks in our area, and this was all banks, to issue CD's, nonnegotiable CD's, slightly above our savings rate. We were hit at that point, but to a manageable degree. But the shocking nature, if you want to call it, a large nature of the increase that has taken place literally, when the saver, a fellow with $5,000 and $10,000——

Mr. HARVEY. I have only 5 minutes. My point to you, Mr. Strunk, was that neither one of you as I understand it, is actually asking this

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committee to prohibit the issuance of CD's. Now, you are asking for certain reforms, but you are not asking that they be prohibited entirely, are you, as H.R. 14026 would reportedly do, according to the way I read it?

Mr. SHERBOURNE. We are not asking that, Congressman, because the amount of CD's is so large in billions of dollars, so many billions, that we think you cannot cure the problem by shutting it off.

Mr. HARVEY. It would cause absolute chaos in the financial market if you were to, overnight, prohibit the sale of CD's? I would think that would be commonsense.

Mr. SHERBOURNE. It wouldn't have that influence if you were to provide legislation that these nonnegotiable CD's cannot be issued for amounts less than $10,000.

Mr. HARVEY. That is exactly the point that I was trying to make a few minutes ago. Neither one of you are asking that they be prohibited entirely, as this bill would reportedly do.

I would like to direct a question to our chairman. I wonder if the Secretary of the Treasury, Mr. Fowler, is going to appear at these hearings?

The CHAIRMAN. We expect him to; yes.

Mr. HARVEY. Is there any time schedule?

The CHAIRMAN. Not right now. We have these witnesses, the Treasury Department—Mr. Fowler will be the one, the Federal Home Loan Bank Board, Federal Reserve Board, Federal Deposit Insurance Corporation, American Bankers Association, and others. On Wednesday, we will hear Chairman John Horne of the Federal Home Loan Bank Board. Tomorrow is the Open Market Committee meeting at the Federal Reserve and they wanted a day or two after that before they came up. But they will be here.

Mr. HARVEY. Thank you, Mr. Chairman. I have no further questions.

The CHAIRMAN. May I suggest this, Mr. Harvey. This lower interest rate on smaller accounts—that bothers me a lot. I feel strongly about this. This is going to ruin the industry if we do not do something about it. We must protect the savings and loans in their efforts to build homes at reasonable prices for the long term.

Mr. HARVEY. I want to do that, too, Mr. Chairman.

The CHAIRMAN. If we pass a law here to say that all accounts under $15,000 may be paid lower rates of interest, why that would be discriminatory against the small saver. I just cannot imagine a Congressman voting for a bill to permit a high rate of 5½-percent interest only on large accounts.

Now, I know that the object of it is good. But if you put yourself in the position of two fellows who come up to the window, one has a million dollars and you say, "Well, we will pay you 5½ percent," and the little fellow with just a few dollars gets only 4 percent.

Mr. HARVEY. That is what we are doing under the participations sales bill. You have a $5,000 limitation there.

The CHAIRMAN. That is different.

Mr. HARVEY. I do not see anything different there at all.

The CHAIRMAN. Two wrongs do not make a right.

I do not say that I would be against this if it could be done some way that would not put you in the position of telling the little man

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we have fixed it so you can have only a small amount of interest. That is the part that bothers me.

Mr. HARVEY. If the chairman will let me respond to what you said. My point before was that I think we have to be very practical in finding a solution to this very serious problem and I do not think that the chairman, in this bill, which would seek to prohibit all CD's—I think this is impractical.

The CHAIRMAN. My bill would prohibit only negotiable CD's.

Mr. HARVEY. I do not think it is a practical solution, and I think what we have been talking about are much more practical steps to be taken and what the witnesses have suggested here.

The CHAIRMAN. All right, would you like to proceed, Mr. Gonzalez?

Mr. GONZALEZ. Yes, Mr. Chairman.

My questions are brief, but I am intensely interested.

First, may I point out to the good chairman that I endorsed this bill by introducing it myself. I introduced the same identical bill and I have a question of Mr. Sherbourne.

You say in your statement, "mortgage interests rates have risen abruptly as a result of the high interest rates authorized by the Federal Reserve Board. In my judgment, it will go even higher."

Well, now, they are at 6 percent now, Mr. Sherbourne. How high do you think they would go?

Mr. SHERBOURNE. In New Jersey, we have a statutory requirement—a statutory limit of 6 percent, and the next development involves charging a point. At this stage, I think 1 point is being charged on most loan applications.

Mr. GONZALEZ. There is no limitation on points?

Mr. SHERBOURNE. No, sir.

Mr. GONZALEZ. Is it not a fact that up to sometime in the 1950's, there was a statutory limitation?

Mr. SHERBOURNE. On points? This is an FHA and GI loan.

Mr. GONZALEZ. Right.

Mr. SHERBOURNE. I am talking, primarily, of conventional loans, which is the major part of our market in New Jersey, and in most States.

Mr. GONZALEZ. It is now, but it is coupled with the same questions I have been asking of Mr. Brownstein and others every chance we have when they appear here. That is, that the FHA area of activity has shrunk, where in my opinion the intent of Congress in its inception; that is, in the inception of the program, was that it would be an instrumentality by virtue of which any American family that desired to purchase a home would have a chance to do so on the assumption that there would be something more attractive on the basis of an FHA-arranged mortgage and conventional mortgage arrangement. But that is completely reversed.

Only 16 percent—and that is not even new housing, that is existing housing, and that FHA. And the reason is, that, well, you know the reason better than I do. But what I am getting at, should we not go back to the congressional limitations that we had in the fifties and up until the fifties in the Eisenhower administration? I think what Congress did then, it left the floodgate eventually open for what we are now passing through.

Mr. SHERBOURNE. My understanding of the origination of FHA and GI loans was that they were intended to meet specific needs that

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weren't otherwise being met by local institutions. For example, in some States, savings and loan associations were not too active and their FHA and GI mortgage was the principal instrument. Also, shortly after the war, in order to encourage no-down-payment loans, which no institution would normally make on its own portfolio, the GI instrument came out.

I always felt that the Congress properly provided through FHA and GI loans, a medium by which needs could be met or an area could be pointed to and we could be encouraged—and, by and large, home financing has operated primarily through the conventional mortgage and, may I say frankly, there are certain advantages to that. We can move much faster, take care of builders and the individuals much faster than when you are involved in a secondary guarantee operation. So I think it is the merger of the two that is the best. If you say, let us then go back to provide FHA and GI loans, if there is no market for them, nobody will take them. Then, you get into direct lending in tremendous volume and at that point you face the problem of providing credit in a period in which governmental policy is to reduce credit, to control credit. And, also, to minimize the impact of the Government. That is another problem.

Mr. GONZALEZ. If you did not have these limitations, the 6-percent limitation, for example, how high do you think it would go?

Mr. SHERBOURNE. In New Jersey, I don't think it would go above 6¼ percent. In California and other areas, where money is needed, the rates are already at 6½ and 7, headed higher.

May I say for our friends in California that it is still a fact that the mortgage needs of the expanding population in that State would not have been met if savings and loan associations were not able to pay a rate which attracted money into that area and enabled them to meet the needs.

Many of our confreres in New Jersey don't like that, but I frankly feel that those institutions ought to be commended for making those kinds of loans with low downpayment to new and young families, and the lending pattern there has been quite different. What I am trying to do is to explain now that the California associations are not charging a higher rate because they want to, but because they have to in order to get the money to meet the mortgage demands that exist.

Mr. GONZALEZ. The California situation is very similar to the Texas situation. As you know, the two States have been, for a few years, suffering the greatest impact from this tight money situation. From my observation and experience, frankly speaking, I feel that some of these programs, such as FHA, for the good they are doing on the basis of original intention of Congress, can easily go out of business and I do not think too many people would be hurt in the purchase of homes that need the homes and should be getting the homes, and should have the credit to give them and are not giving them unless they pay exorbitant points and go in there to the market and get this.

Any time you pay 4 points, which means $500, $600, just for the pleasure of getting somebody to handle the mortgage—I say that is highway robbery that has been legalized in this country. And something ought to be done about it at the State level or Congress, wherever it ought to be. And in many cases, it is at the State level, the interest of the people have been sold out to the special interests, and I think this is exactly what is happening nationally right now.

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I think the trend started on this other level of governmental subsidizing the loans when the risks unwisely removed the limitation on these points. It played right into the hands of the people who are now profiting. They are making plenty of money. They could care less whether the average American family gets a home or not.

Mr. SHERBOURNE. Mr. Congressman, may I respectfully point out that only 6 months ago, there were not too many complaints about the availability of mortgage funds and now interest rates in our own institution and in most institutions were at a very low rate, and therefore, from my point of view, the condition would be met, the average American family was getting its loans at the lowest rate in recent years.

All of this has changed in the last 3 or 4 months, to a major extent, because of the problem we are discussing this morning and that is the only reason we are appearing before you on what might appear to be an interbank or interfinancial institutional competitive matter, because the problem has become so severe that consideration should be given as to how to cure it.

Mr. GONZALEZ. This has not been my experience at all in my area. I have been having complaints for years, since I was in the State senate, and this may be unusual, abnormal, or what-have-you, or it may be that those of us who have to go in and deal from another angle, see a different picture. Of course, people who are buying—most families who want a home will sacrifice a great deal and they have no defense—there is nothing they can do. They are over a barrel. If the elected representatives on either the State level or the national level sell out the people's basic interests, there is not a thing the people can do.

The CHAIRMAN. We will stand in recess until 10 o'clock in the morning and ask these gentlemen to be back with us. We want every member of our committee to have the privilege of interrogating you.

(Whereupon, at 12 o'clock noon, the committee adjourned, to reconvene at 10 a.m., Tuesday, May 10, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

TUESDAY, MAY 10, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Multer, Barrett, Reuss, Ashley, Moorhead, St Germain, Gonzalez, Weltner, Hanna, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Widnall, Mrs. Dwyer, Clawson, Johnson, Stanton, and Mize.

The Chairman. The committee will please come to order. Yesterday we had gotten down to Mr. Gettys, I believe. He is not here so I believe that Mr. McGrath is next.

STATEMENT OF NORMAN STRUNK, EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS & LOAN LEAGUE, AND EVERETT C. SHERBOURNE, PRESIDENT, CITY FEDERAL SAVINGS & LOAN ASSOCIATION; ACCOMPANIED BY WILLIAM F. McKENNA, GENERAL COUNSEL, NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS—Resumed

Mr. McGrath. Thank you, Mr. Chairman.

I want to welcome Mr. Sherbourne, a fellow New Jerseyite.

I have a question concerning the CD's.

Suppose a citizen walks into a bank and deposits $10,000 and receives a certificate of deposit. Is that transaction covered by FDIC insurance?

Mr. Sherbourne. To the extent of $10,000.

Mr. McGrath. It makes no difference whether it is a negotiable or nonnegotiable certificate of deposit, the insurance aspects?

Mr. Sherbourne. I don't believe so. I don't believe it makes any difference.

Mr. McGrath. Is there any place in the country where an individual can walk into a savings and loan association and receive a certificate of deposit?

Mr. Sherbourne. We are not permitted to issue any instrument that guarantees a definite rate for a period of time, therefore we cannot issue CD's.

Mr. McGrath. That is all I have.

The Chairman. Mr. Mize?

Mr. Mize. Thank you, Mr. Chairman.

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What percentage of this $17 billion plus in CD's now outstanding is in negotiable and what percentage is in nonnegotiable?

Mr. SHERBOURNE. The total amount of CD's is about $35 billion and of that $17 billion is negotiable and the other is nonnegotiable.

Mr. MIZE. It is about 50–50?

Mr. SHERBOURNE. I think it is. I think a little more than 50 percent is nonnegotiable.

Mr. MIZE. Did I understand you yesterday to say that only about 10 percent of the outstanding CD's are of concern to you; that is, the small denominations affect your area?

Mr. SHERBOURNE. I don't have any figure.

Mr. STRUNK. If I mentioned them, then I was not fully conversant with all the facts. We are concerned with the nonnegotiable CD's.

Mr. MIZE. Only?

Mr. STRUNK. Primarily.

Mr. MIZE. Only 10 percent are in denominations that affect you people?

Mr. STRUNK. I would not say that. I really don't have the figures. I think most of the nonnegotiable CD's are in units of $10,000 or less. Of course, any time you get in units of $10,000 or less it is a new high rate kind of competition for your accounts.

Mr. MIZE. These smaller denomination CD's are the kind that you are all disturbed about have come into existence, so to speak, only in the last 2 or 3 years. You did not anticipate that kind of thing when it got started back in 1960?

Mr. STRUNK. I think that's correct.

Mr. MIZE. That is all, Mr. Chairman. Thank you very much.

The CHAIRMAN. Mr. Gettys.

Mr. GETTYS. Mr. Chairman. Mr. Strunk, Mr. Sherbourne, I would like first to congratulate and commend the savings and loan industry for the magnificent job that is done in helping so many individual Americans realize the dream of homeownership. I do not know of any agency that has contributed more to the stability of the family and the realization of the American Dream in that connection than the savings and loan industry. I am very concerned about the overlapping of functions that are proposed between the banking industry and the savings and loan industry, if we can call it an industry. I believe that there is a place for each of the services without overlapping.

Now, did I understand, Mr. Strunk, you to say yesterday in your formal statement that interest rates do not have much effect on the amount of savings?

Mr. SHERBOURNE. I think I said that, Mr. Congressman. That an increase in the interest rate does not generally have much effect on total savings. My understanding is that most economists agree with that statement that an increase has some impact, but not significant.

Mr. GETTYS. If that is a fact, and I assume it is, most laymen have a different opinion.

Mr. SHERBOURNE. Well, if I could just finish. When I say that economists make the statement that an increase in the interest rate does not generally increase savings, I mean that the total savings held by individuals is related to their consumptive habit, their desire to spend for things and services rather than to the interest rate. How-

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ever, the interest rate has this function, that the interest rate which savings and loans pay on their savings deposits, the commercial banks do on theirs, the rate our finance companies pay for the certificates and instruments they issue, all with respect to the total amount of savings, the rate paid in any particular field determines the extent and proportion of total savings that shifts into that field.

Mr. GETTYS. I understand. In the savings and loan field an increase in the interest rate may affect it, but overall it may not.

Mr. SHERBOURNE. The effect is that it affects the distribution of total savings, but the high interest rate in any particular field is not going to make much significant impact on the amount of total savings by all individuals in the country.

Mr. GETTYS. Thank you, Mr. Sherbourne. Mr. Strunk, did I understand you correctly when I got the impression that so far as the CD problem is concerned now, as it relates to the savings and loan industry, it could be cured without legislation, that is, by administrative action by the Fed?

Mr. STRUNK. Mr. Congressman, the suggestions that we have offered both to the Federal Reserve and to the committee yesterday we believe can be effected without legislation as we have looked at the law ourselves. And those two suggestions are, that the Fed prohibit banks from issuing CD's which are automatically renewable, and also prohibit banks from issuing certificates which have more than one maturity date.

For example, a typical savings bond issued by a bank has a 5-year maturity. But the saver can cash that bond in after 30 or 90 days, which is what I mean by dual maturity dates.

So, if the banks issued certificates which were not automatically renewable, and had only one maturity date, this would make the certificate like the money market instrument I believe it was first intended to be. It was to take on the characteristics of a Treasury bill and we believe then that this would take the certificates generally out of the savings market and put the savings business back where it always was; namely, into the passbook area. We believe that those two things can be done without legislation.

Mr. GETTYS. Do you recommend that?

Mr. STRUNK. Yes, sir, yes, sir; we do recommend it.

Mr. GETTYS. Have you had any evidence from the Federal Reserve, any clue as to its position on the subject?

Mr. STRUNK. We have no clue. We wrote a letter to Mr. Martin, Chairman of the Board of Governors last month and we had a very nice acknowledgment of our communication, but no clue as to whether the Fed would take action along this line.

(The letter referred to follows:)

UNITED STATES SAVINGS AND LOAN LEAGUE,
Chicago, Ill., April 11, 1966.

Hon. WILLIAM MCCHESNEY MARTIN, JR.,
Chairman, Board of Governors,
Federal Reserve Board, Washington, D.C.

DEAR CHAIRMAN MARTIN: My last letter to you, dated December 13, 1965, followed receipt of the news of the change in the discount rate and the change in regulation Q. We were primarily concerned at that time, as we are now, with the change in regulation Q.

In view of developments since last December, we are convinced our concern at that time was more than justified. The decision of the Board of Governors

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to raise the permissible rate on commercial bank time deposits to 5½ percent opened a Pandora's box in the savings marketplace and has provoked a "rate war" for savings in which the financial institutions in the country are now engaged. In our view, this price war in the savings market is most regrettable and can only result in a weakening effect upon financial institutions generally.

We recognize full well that decisions and policies of the Board of Governors were made in the belief that increased rates and tighter money were necessary to inhibit the development of inflationary pressures in the United States. Thus, the program of monetary restraint in high interest rates inaugurated by the Federal Reserve Board evidently has been inadequate to prevent a serious inflation threat. The threat of inflation is, in our judgment, considerably more serious today than it was early last December.

On behalf of the savings and loan business, the United States Savings and Loan League is urging President Johnson and Members of Congress to take measures in the fiscal area designed to curb the inflation threat. We believe that you should be aware of these efforts and we would hope that in the interest of promoting stability in the economy the Board of Governors of the Federal Reserve Board would express itself to the White House and to the Congress on the same subject. Perhaps it is time for the Federal Reserve Board itself to acknowledge, as many now acknowledge, that heavy dependence on monetary policy in fighting inflation cannot be regarded as a complete success.

As you recall, our original concern over the change of regulation Q was that it foreshadowed a serious diversion of funds away from housing and home ownership. Our forecast has been validated in recent weeks; housing starts in February were 17 percent below the same month a year ago and we would be surprised if this decline does not continue over at least the next few months. Recent monetary policy decisions have meant, in other words, that the housing industry has been affected more adversely than any other major industry. Certainly the Board recognizes that the housing industry has been in a depressed state for several years and has not contributed to the inflationary pressures of recent years.

We urge, therefore, that the Board undertake a reconsideration of recent decisions with a view of determining whether these decisions have not imposed an unduly and unfairly heavy burden and hardship upon the homebuilding industry and the real estate business.

The second part of our objection to the change in regulation Q was that the change would mean a substantial shift in funds from smaller banks and specialized financial institutions into large-money-market banks which would be able to pay the highest rates on certificates of deposit. We realize that you personally called for "prudence" in the use of the new ceilings. Day by day, however, the evidence mounts that your warning has been disregarded by many banks.

In all frankness we are not reassured by the March 21 publication of your survey of use of new time deposit ceilings as of December 22, 1965. A survey of that date must be regarded as very much out of date since many hundreds of banks have been moved to high rates since December 22. Furthermore and of even greater importance, your survey was based on the number of Federal Reserve member banks offering high-rate statistics. A more accurate analysis of the extent to which the banking business of the country has taken advantage of the new ceilings would be gained by a survey of the extent to which the major banks of the country have undertaken promotion of these small denomination certificates of deposit.

We have undertaken such a survey of the hundred largest banks in the country which hold nearly 50 percent of all deposits of the commercial banking business. Our survey reported that more than three-fourths of the hundred largest banks offer "consumer CD's." These 78 banks hold over 40 percent of all commercial bank resources in the country. Very clearly, the offering of these consumer CD's at rates approaching and exceeding 5 percent by the banking business is considerably greater than the survey reported by the Federal Reserve Board on March 21, 1966.

We urge, therefore, the Board of Governors to make a new survey to find out exactly what the banks—and particularly the large-money-market banks—are doing in promoting saving certificates. We suggest that a survey today would reveal a substantially different picture than was reported in your survey on December 22.

The change in regulation Q last December was restricted to time deposits, which indicated a hope or belief on the part of the Federal Reserve Board

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that the new time deposit ceilings would not be used primarily in competition for personal savings. Of course, the tremendous volume of newspaper advertising announcing the availability of small denomination certificates of deposit and savings certificates makes it clear that the new ceilings are being used to an ever-increasing extent in the solicitation of personal savings. Unless some new restrictions are imposed on time deposits, therefore, there promises to be increasing disruption of the savings market.

Two possible and constructive restrictions on time deposits immediately available to the Federal Reserve Board are (1) to prohibit the issuance of certificates with more than one maturity date, and (2) to eliminate the automatic renewability feature on certificates issued in the future.

Perhaps the most ironic and bitter twist of the hectic events in the savings market since early December is that the "rate war" in the savings market has done so little to promote savings in financial institutions. The growth of time deposits and savings in commercial banks during the first quarter of 1966 was much lower than in the corresponding quarter in 1965. The growth in savings accounts in mutual savings banks was lower in the first quarter of 1966 than it was last year. The growth in savings balances at savings and loan associations was considerably lower in the first quarter of this year than in the first 3 months of last year. Thus, banks and financial institutions over the country are paying more for savings and time deposits and are attracting less. By any measure, this must be reckoned as a hollow and expensive victory even for the few big banks that have grown in recent months.

Changing the rules under which certificates of deposit are issued, as outlined above, with respect to dual maturities and automatic renewability would be consistent, we believe, with the Board's objectives as to savings deposits outlined in your speech in December to the Life Insurance Association of America. At that time you indicated that the Board desired to minimize the impact on competitive relationships between commercial banks and savings banks and savings and loan associations, which depend for their resources mainly on funds deposited by individual savers rather than by corporations.

In closing, we cannot urge you too strongly to pursue with the greatest vigor at your command your efforts to police the volume and nature of commercial bank lending because this is the heart of the matter. Commercial bank loan-to-deposit ratios are higher than they have been in virtually any other period in our economic history. A good part of the inflationary pressures could be checked by greater selectivity in commercial bank lending.

In connection with some restraint in commercial bank lending, the Board of Governors might appropriately, we believe, ask for some voluntary restraint or reduction in the total amount of credit extended by the commercial banking system in the consumer credit area. This would urge some reduction both in the total amount of consumer credit extended by the commercial banks directly and also the extent of commercial bank financing of sales finance and other consumer credit companies.

We congratulate you most heartily on the fact that you have urged restraint and caution in commercial bank lending, and we urge further and renewed efforts along these lines.

Sincerely,

NORMAN STRUNK,
Executive Vice President.

Mr. STRUNK. Now, we do know that the Fed and the FDIC are making new survey to get new facts with respect to commercial bank usages of certificates, rates paid, denominations and so forth.

Now, the Fed made such a survey as of December 18, I believe, and the results of that survey were released sometime in March or April. At the time the Fed released the results of its December survey, it was obvious those facts were completely out of date and it is quite appropriate that the Fed get new facts, get current facts as to commercial banking practices in this area.

It may be that this survey is made somewhat in anticipation of making changes in commercial bank CD practices.

Mr. GETTYS. Thank you, Mr. Strunk. It would seem to me that in matters of these kinds that if the existing agencies could take corrective

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action it would be better than having to obtain legislation because it takes so long.

Mr. SHERBOURNE. May I add to that statement?

Mr. GETTYS. I believe my time has expired.

The CHAIRMAN. Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

Mr. Strunk and Mr. Sherbourne, I would like to associate myself with Mr. Gettys' remarks concerning the importance of savings and loan associations. One of my close and dear friends in Kalamazoo, Mr. Paul Gray, is with the First Federal Savings and many times he has told me of the great satisfaction he has gotten out of his association with that firm because he has helped many, many people buy homes in that community. I am concerned that the savings and loans as an institution should not be weakened by actions of Federal agencies or other agencies and that their competitive position be maintained.

Mr. Sherbourne, in your statement yesterday you submitted a table on page 4, and I am not entirely clear as to the significance of that table. In 1966 you indicate that other time deposits have amounted to 70 percent and negotiable CD's to 9 percent of the time deposits in weekly reporting member banks. The other time deposits—are they equivalent of nonnegotiable CD's?

Mr. SHERBOURNE. Yes.

Mr. TODD. These are not what we think of as savings deposits?

Mr. SHERBOURNE. These will not include savings deposits.

Mr. TODD. The two together are really the ones that represent the CD impact on the savings field by banks?

Mr. SHERBOURNE. Yes, sir.

Mr. TODD. The other time deposits would be the time deposits which in a sense would be those taken out of savings and loans in response to high interest rates paid by commercial banks? Would that be an analysis of the situation?

Mr. SHERBOURNE. Yes, although it is possible that the negotiable CD's also have some deposits.

Now, may I point out that these are increases that occur, not the total amount that exists.

Mr. TODD. But the significance of that 70 percent then would be really, that this year there has been a great change in the savings pattern and particularly among the smaller savers; is that correct?

Mr. SHERBOURNE. Yes.

Mr. TODD. This is precisely the area in which you are worried and where the impact in savings and loans has been felt?

Mr. SHERBOURNE. Yes, sir.

Mr. TODD. Fine; that explains that to me, then.

Yesterday, Mr. Strunk, in your statement you indicated that the regulation Q was changed in December by the Fed in response to a potential liquidity crisis when CD's were coming due. As I understand that, there would have been a withdrawal of this money from the banks and the money would have been placed in other paper, presumably; is that correct?

Mr. STRUNK. That is correct.

Mr. TODD. What would the other credit instruments have been? In other words, what were the alternatives open to the corporations that had the CD's on deposit?

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Mr. STRUNK. Treasury bills, obligations of various Federal agencies, commercial paper issued by finance companies, and other corporations.

Mr. TODD. At that time the interest rates on these other types of paper were higher than those which the banks were paying in CD's; is that correct?

Mr. STRUNK. I am not positive they were higher, but the margin was such that there would have been switches out into other money market instruments. I am not positive the Treasury bills in December were more than 4½ percent. When the rediscount rate went up to 4½ percent it was inevitable that these short-term money market instruments would go to higher levels which meant that banks could not have persuaded the corporations to keep their money in these CD's, but they would have to go into other instruments.

Mr. TODD. Could not the Fed have achieved the same goal through open market purchases of Government bonds? That would have put money back into the market.

Mr. STRUNK. Yes, sir, the Fed can, of course, generally keep levels of interests at about what it wants to keep them. The particular policy being pursued at that time, however, was to raise interest rates or permit interest rates to go up in response to increasing demands for funds, and the Fed was pursuing a deliberate policy of taking it by means of higher interest rates and that is one reason they raised the discount rate. They were deliberately pursuing a high interest rate policy.

Mr. TODD. Yes, and I think, of course, in terms of at least conventional economic thinking there would be justification of that period of inflation, but that would not necessarily coincide with the liquidity prices on CD's. It seems to me anyway.

Mr. STRUNK. Liquidity prices in CD's resulted as a result of pursuantly high interest rates. Again, the negotiable CD is a money market instrument and corporate money goes in and out of these as corporate treasurers decide where the best place is for the short-term investment of their funds.

Mr. TODD. A negotiable CD is almost the same as a debenture maturing in a year?

Mr. STRUNK. It is precisely that—a debenture connotes a longer term such as 5 or 10 years, but it is precisely the same as a Treasury bill. Short-term promise to pay. It may not be short term. It may run as long as a year. But the practice of the New York banks in first offering these certificates, negotiable certificates, was to offer them for about 6 months or a year maturity and then a market was created in a negotiable market and over-the-counter market so that the corporations who held them could get out of them by sale to someone else. Since the CD's have begun to be issued for shorter time periods, 30 and 90 days, the negotiability and the making of a market for these instruments has become less important.

Now, the corporations are buying shorter maturities to coincide with the demand or the need of the corporation for cash. So, a lot of corporations purchase CD's to mature on March 15 and again to mature on April 15, because they were the dates the corporations needed cash for taxes and dividend payments and so forth.

Now, corporations could have put the money in the checking accounts and have left them there, but it wouldn't have earned anything

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on that idle cash, or they could have put it in Treasury bills to mature on those dates, or other kinds of short-term paper, including obligations of the FNMA and the Federal Home Loan Bank System and so forth.

Mr. TODD. Thank you, my time has expired.

The CHAIRMAN. Mr. Johnson?

Mr. JOHNSON. Thank you, Mr. Chairman.

I notice, sir, in your testimony that there might have been a virtual crisis in December—you say the banks were faced with the necessity of liquidating $3.5 billion in maturing obligations and that is the reason that the discount rate was raised. If there was that type of a crisis, what can you conceive of a crisis occurring if this bill were passed? Supposing this bill were to pass and the banks were denied the right to issue negotiable certificates of deposits or other evidence of indebtedness? What would the banks do with these CD's that they have now? Would there not be another virtual crash of our banking system?

Mr. SHERBOURNE. Mr. Congressman, I am not an expert on central banking theory, but obviously, if the banks were not able to continue to pay a good rate on those negotiable CD's they would be withdrawn by corporations and it would create liquidity problems for commercial banks. Therefore, I am not sure any prohibition can be made immediately mandatory. However, it is clear that we have a problem that developed over the course of 4 or 5 years because these negotiable CD's which are really short-term money, began to require by Federal Board action a rate of return that in previous years had been restricted by the reserve bank to longer term investments of 6 months or more. So that, therefore, from a long-range point of view, the real problem rests before this committee as to whether these negotiable CD's should not be eliminated or restricted to a certain proportion of banking deposits. But that is an area in which the committee, I think, would have to get the opinions of better experts on central banking theory than myself.

Mr. STRUNK. May I suggest, I think obviously there would have to be some phaseout period to phase out over a period of several years, maybe.

Mr. JOHNSON. Another question, sir.

Your support of this type of legislation seems to be predicated on the fact that there is a remarkable and striking and worrisome decline in the availability of funds for mortgage lending which of course affect you people. If you were here today, let us say, to testify with respect to the sale by FNMA of $5 billion worth of participation certificates which is the bill that the Senate passed, would you, by reason of the fact that this would be a drying up of money available, be against that type of financing?

Mr. SHERBOURNE. It would have an impact, Congressman, but if it is necessary for the U.S. Government to carry on that type of operation, then the private institutions must adjust themselves as well as they can to that problem.

Mr. JOHNSON. You would live with that type of a practice, but you cannot see how you can live with the practice of issuing certificates of deposits, is that right?

Mr. SHERBOURNE. The reason for that is that we submit that for years, by action of the Federal Reserve Board itself, they provided for a low interest rate on this type of short-term money—you can call it hot money or it almost comes close to demand deposit.

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May I point out that until 1962 the rate permitted on deposits—time deposits over 30 days was only 1 percent and by 1964, even in 1964, it was only 1 percent and at that point was increased from 1 to 4 percent. The reason for that must be because the negotiable CD's market had developed to such a degree and in such a volume, that in short-term interest rates and the Treasury market and in the financing market generally they were beginning to touch and exceed the rates paid on all CD's in order to prevent the shift of bills from these CD's into other phases of the market and then the Federal Reserve Board authorized a high rate on the short-term negotiable CD's.

It therefore seems to us that the onus is not on us to establish why this should be changed, but actually, I think it is up to the Federal Reserve Board to explain why they took this action—why such a sharp departure in the course of just the last 3 or 4 years and particularly why, in December of last year did they permit a CD rate which is so high above the rate they permitted in their own savings deposits—why did they permit such a sharp differential? They could have realized that the net result of that was going to be the cause of diversion of substantial amounts of sums from commercial bank deposits as well as from savings and loan accounts.

Mr. JOHNSON. Did you put a figure into the record as to what the total amount of these certificates of deposits are now, nationwide? Is it a large sum of money?

Mr. SHERBOURNE. I have a current figure on negotiable CD's which I think is $17.5 billion and my understanding is that the nonnegotiable CD's amount to $15 billion or $16 billion.

Mr. JOHNSON. That is all. Thank you.

The CHAIRMAN. Mr. Ottinger?

Mr. OTTINGER. Thank you, Mr. Chairman.

I would like to congratulate both of the witnesses on their excellent testimony outlining the problems that have been created by the expansion of these negotiable and nonnegotiable CD's. I know all over the country I have been hearing from builders and savings banks people and savings and loan institutions that this is a very real problem. I would like to explore with you a little bit the solutions.

I have a bill that is related to this subject, H.R. 14422, which the chairman has very kindly consented to consider as a germane amendment to the pending legislation. My bill would limit these time deposits to $15,000 and higher.

I would like to read from a letter which I received, dated April 29, 1966, from Stephen Slipher, legislative director of the United States Savings & Loan League with respect to this legislation. With your permission I would like to have the letter included in the record.

The CHAIRMAN. Without objection, so ordered.

(The letter referred to follows:)

UNITED STATES SAVINGS AND LOAN LEAGUE,
Washington, D.C., April 28, 1966.

Hon. RICHARD L. OTTINGER,
House of Representatives,
Longworth Building,
Washington, D.C.

DEAR CONGRESSMAN OTTINGER: I appreciated your letter of April 25, regarding your bill, H.R. 14422, to prohibit time deposits in banks in amounts less than $15,000.

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The United States Savings and Loan League unqualifiedly endorses this measure. I would imagine that every savings and loan association, every savings bank, and even a majority of the commercial banks would favor the bill.

In December we wrote Chairman William McChesney Martin recommending that a $25,000 or $50,000 "floor" be established for certificates of deposit. The response was that it wasn't legally possible to make such a distinction by regulation.

We have never quarreled with the necessity of commercial banks paying an attractive rate on the huge certificates of deposit purchased by major corporations, but we have bitterly resented the use of CD's for the passbook-type savings in amounts of a few hundred or a few thousand dollars. Furthermore, much of the advertising creates the impression that such certificates of deposit are ordinary savings accounts.

We hope that the Congress will give early consideration to your bill and we would be happy to testify in person in support of the measure.

Sincerely,

STEPHEN SLIPHER, *Legislative Director.*

Mr. OTTINGER. One possible solution to this problem has been recommended to me by a number of commercial bankers to give the Federal Reserve bank the authority to set limits on the denomination of CD's. We heard from Mr. Sherbourne, however, testimony in his statement that was highly and I think justly critical of the Federal Reserve Board in this matter.

It would appear that the Fed has been responsible for creating this problem in large part through its permitting a 5½-percent rate on the certificates of deposit. Would you be sanguine with a measure which merely gave the Federal Reserve Board the power to set such a floor? Do you think the Board could be counted on to act and act adequately?

Mr. STRUNK. We would be very happy to have the Fed have the power. Then at least it wouldn't have the excuse that they can't legally do it. I don't know whether the Fed would set a floor if it could, but at least, if legislation were passed permitting the Fed to do it, they could not retreat to a legal opinion that they can't do it.

It would be better to direct the Fed—maybe direct the Fed to set a floor or permit the Fed to set a floor no lower than $15,000 or $20,000.

Mr. OTTINGER. Mr. Sherbourne?

Mr. SHERBOURNE. The situation at this point seems to be serious enough to have the Congress establish the lower limit and give the Federal Reserve Board the right to make it higher if they wish.

Mr. OTTINGER. You have no objections, I take it, to large denomination certificates of deposit as far as your industry is concerned?

Mr. SHERBOURNE. We do not, sir, because we believe most of our savings are in amounts under $10,000 and therefore the impact on us would be minimal—something that we could support, and something that wouldn't affect the home-financing market too greatly.

Mr. OTTINGER. I suppose one of the justifications the Federal Reserve will give, and we will be hearing them, I take it, in the course of these hearings, for raising the rates on the certificates of deposit is that it was an anti-inflationary measure. As I understand it, and correct me if I am wrong, the effect of the increased interest on the certificates of deposit has not been to restrict credit generally, but only to discriminatorily restrict credit in the field of home financing, mortgage financing. It takes money away from the savings institutions which performs that function and makes credit more readily available in the industrial sector.

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Mr. SHERBOURNE. Mr. Congressman, I want to make it clear that I am not critical of the Federal Reserve Board as I think I mentioned in my testimony. I have a great deal of respect for the manner in which they have controlled the money market in recent years.

I think what happened here is that under pressure and demonstrated evidence from large commercial banks, a negotiable CD market was built up and then because of the necessity of maintaining deposits here and preventing a drift of deposits abroad, the short-term rate in the Treasury market got higher and higher and finally in December the Federal Reserve Board was faced with a problem and they had to take some action. The question from this point forward is whether that problem is of such magnitude and whether there is a possibility of a recurrence such that the Congress shouldn't help by imposing a limitation, and I hope that perhaps there would be some limitation resulting from their own volition.

Mr. OTTINGER. Thank you very much. My time has expired.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Mr. Hansen.

Mr. HANSEN. Mr. Chairman, I'm sorry to be late. I do not want you men to get the notion that I am negative toward your position, but we are talking about a problem which I think is somewhat more deepseated and has a little history behind it that I would like to draw to the surface.

I live in the Middle West and competition for money started 5 or 6 or 7 years ago and the aggressors in the case were the members of your association from the west coast. I think the things that have been going on among the banking fraternity in our area, at least, were defensive moves.

Now, we are talking about the validity of these negotiable certificates. I understand that you have indicated, that you are amenable to the idea of limiting these to a minimal figure thus getting them out of the category of the saver item. Well, this of course was objected to by our chairman, Mr. Patman, and I think advisedly so because this would in turn create a situation where the little fellow could not get the benefit of the higher rate. The higher rate would be made exclusively for the monied men. We are small money people in the Middle West. We do not think in the same terms that you do back in this part of the country. I am all for the little fellow, because I am one of them and I think we need the little fellows in the country to carry on the whole total load with which we are faced. Therefore, I would think that you men would, instead of fighting this thing, propose that we fix it so that the banking fraternity could share with you the same position on, we will say, in the passbook savings field, by suggesting that the rate permissible to the banks on passbook accounts be put more at a level with what you men in your industry are paying, and advertising, as your interest rate.

I would like to have your comments on that suggestion, please.

Mr. SHERBOURNE. The record of the Federal Reserve Board on rates that they permit on savings accounts is clear that in recent years they permitted commercial banks to be competitive on the rate, because the rate that most of them were allowed to pay was fairly close to the highest rate the savings and loan associations were then paying.

It is clear, Mr. Congressman, that so long as commercial banks are advertising one-stop banking, all-service banking, and private, per-

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sonal loans, equipment loans, automobile loans among everything else with which to attract customers to themselves, they also get their savings deposits and commercial deposits along with it, but the savings institutions are going to have a problem if they are not permitted to have a slightly competitive advantage—maybe like a quarter of a percent.

Now, therefore, it is that area to which the Federal Reserve has effectively manipulated and controlled and permitted our institutions to get proper amount of savings. But in these negotiable CD markets and in the high rates they are permitted recently, it obviously has created great distortions and the Congress of the United States I always understood is concerned with the availability of credit and home financing.

I asked my Congresswoman, Mrs. Dwyer, in my district one time why this committee and the House was so slow and cautious in permitting us to have additional lending powers, even to the extent of permitting loans for equipment in homes, and she said to me that the Congress is most concerned that there be sufficient credit for housing. So I think by this demonstrated record of Congress, they are as much concerned with this objective as we are.

Mr. OTTINGER. Will the gentleman yield? Is it not the small fellow who is being hurt by these CD's because he cannot get a loan to buy his house?

Mr. STRUNK. That will be the record; yes, sir. Come late summer and early fall he will find—the typical family man that wants to buy a house will find—he will find himself unable to get the credit for it as a result of the draining away of money out of our institutions into the CD market.

Mr. OTTINGER. Thank you.

Mr. HANSEN. The whole point that I want to draw out here is that we cannot take a meat ax approach to this thing. On the other hand, it is a fact that in every competitive situation, in every business, one or the other of the other competitors finds himself at a tactical disadvantage he is going to back into his office, sit down and figure out all the steps necessary to cope with the situation.

My notion of what happened in this case is that the banking institutions have done just that by developing this negotiable CD proposition on an energetic basis.

My time has expired. If you would like to make any further comments on this point, I'd appreciate seeing it in the record. Thank you.

Mr. SHERBOURNE. Mr. Chairman, may I be permitted to make a comment and charge it against my time.

I want to make sure that the members of the committee understand that our testimony comes not from the sense that we want the committee to take this away—we would not be here if that were the case. We would submit that there are two problems of international significance that exist. One is that the negotiable CD market has become so large and so great that it represents an interference with the Treasury market and the bill market and the short-term market and to that extent has an impact on Treasury financing operation.

The second is that the enormous—the torrential increase that developed last December has created such a transfer problem in savings from our institutions that it now limits and inhibits our capacity to

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take care of the existing volume of home financing applications that we are receiving. You find no problem in those. You find no problem in those two areas, then take no action.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Mr. Strunk, I wonder if you can clarify one point for me, please. In answer to a question from Mr. Harvey yesterday, did I understand you to say that your big problem is consumer CD's and that this practice of consumer CD's in small amounts are primarily issued by the large banks only?

Mr. STRUNK. If I understand your question, we are mostly concerned with the consumer CD. As we have seen this develop, it has developed primarily in the larger banks, in the larger cities, but it is rapidly spreading to the smaller banks throughout the country and in the small communities.

Smaller banks are having to do this as a defensive matter against the big banks and you will find bank promotion of CD's now spread out over the country where in the few days after the selling went up to 5½ percent it was primarily a phenomenon of big banks, plus some aggressive new small banks, but in the main, the older, smaller banks did not get into this until recently.

Mr. STANTON. I want to clarify that point because it was my understanding that the practice was spreading throughout the bank industry.

Secondly, I had the occasion over the weekend to spend some time with a commercial banker and I would presume that when they testify on this bill their big complaint will be the same as yours. It is tight money and they were crying equally as hard and as eloquently as you people have presented your case here today. If that is the case, both the commercial banks and savings and loan institutions are in this tight money situation. Would you have any particular suggestions, if you agree with that premise, what this committee might do to help alleviate that situation?

Mr. STRUNK. There are several ways to attack the inflation problem and I think we have tight money because of the inflation problem.

If the economy is overexpanding, there are shortages of everything. Inflation problems and the problem of an overexpanded economy straining at the leash can be attacked in two ways, through monetary policy through Federal Reserve action in connection with the amount of credit available and the other is through the fiscal area—fiscal tools.

There are two general types, one the general areas, the general level of Federal spending and the other area is tax policy and tax increases have been recommended, recommended by the United States Savings & Loan League and many groups, of course, have urged an attack on the inflation problem through the other fiscal means; namely, a reduction, some reduction in Government spending.

Given a reluctance to use fiscal measures, then you have tighter and tighter money and you have a greater and greater demand for money and for credit on the part of businesses who find the opportunities to make things and sell things so great.

Mr. SHERBOURNE. May I point out that the Federal Reserve Board announcement, when they changed the interest rate ceilings in December, had two interesting sentences which indicate the nature of the problem.

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They said, with respect to the action on the rediscount rate, that it is intended not to cut back on the present pace of credit flows, but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures. Later on they said that the increase in the rates that member banks are permitted to pay their depositors is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective the savings funds already available in the economy to finance their loan expansion.

As far as inflation in a given field by corporate building is concerned, it doesn't make much difference where the savings comes from, or where the money comes from, whether it is created by demand deposits by a loan from the bank, or whether it is created by deposits that come into the bank and then are reloaned by the bank. The pressure on prices in that field depends only upon the loan extension. It seems to me that within the extension of the Federal Reserve Board in December, you see a little contradiction.

Mr. STANTON. Thank you very much.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Mr. Chairman. Mr. Strunk, what rate are the Chicago banks paying on their CD's?

Mr. STRUNK. The larger banks are paying 4½ percent on so-called consumer CD's.

On negotiable CD's, they are paying considerably higher rates that would have to be competitive with the rates paid by New York City banks.

As far as the consumer area, 4½ percent with a few banks paying 5.

Mr. ANNUNZIO. I have talked to many of the bankers in Chicago and I was informed that they were paying 4½ percent. Yesterday, I noted in the Wall Street Journal that the Morgan Guaranty Trust Co. is raising its rates to 5½ percent and if that happens, do you think a lot of the Chicago money will go into New York unless the Chicago banks raise their rates? You are going to have a real tight-money situation in Chicago as far as our savings and loans are concerned.

Mr. STRUNK. Again, the 5½ percent rate, I believe, announced by the Morgan Guaranty relates to the so-called corporate depositor—the negotiable CD. I have not yet heard in the consumer area that the New York City banks are paying 5½ percent for the CD's. But so far as the New York City banks raising their rates, and CD's generally, it takes money out of the Chicago banks and it takes money out of the banks in Keokuk, Cedar Rapids and everywhere into the big city banks.

Mr. ANNUNZIO. Well, in your opinion, the crisis is here and something must give or something must be done, whether it is by this committee or by administrative actions of the Federal Reserve Board.

Mr. STRUNK. Precisely.

Mr. ANNUNZIO. I want to read back your statement on page 12:

> **This use of certificates of deposit for ordinary savings was not predicted by the Federal Reserve. In fact, the Federal Reserve Board has publicly cautioned the banks against this disruptive competition.**

I am concerned about a statement such as that. The Federal Reserve Board is a board composed of seven men. When it voted to increase the discount rates, the vote was 4 to 3. These are seven out-

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standing economic authorities. For the Board to issue a statement cautioning banks against disruptive competition and, at the same time, not be able to predict or to forecast that this very situation was going to happen is strange indeed to me. Why were they not in a position to see that 6 months later they would be cautioning people about the very condition they created?

Mr. STRUNK. As a matter of fact, Mr. Congressman, Mr. Martin, the Chairman, cautioned the banks in December, 2 weeks after the action was taken.

Now, whether he could have, or should have seen that many banks would immediately jump to 5½ percent, or the 5-percent certificate, I don't know. I would have thought that he could. But within 2 weeks he felt it appropriate to caution the banks about the use of higher rate certificates.

Mr. ANNUNZIO. It seems to me that he, as Chairman of the Federal Reserve Board—and he has appeared before this committee, I have a great deal of respect for his ability—could have forecast the very situation that he cautioned against. I am concerned about the Federal Reserve Board—I think the responsibility lies with them. In other words, they could have forecast this thing and have promulgated the very rules that you brought before us so that we would not be in the condition that we are in today. Do you agree with that?

Mr. STRUNK. I heartily agree with this. In connection with these flows of funds, other lenders, in connection with mortgages, other mortgage lending institutions, the commercial banks and the insurance companies dropped out of the mortgage market at the beginning of last year and now as a result of unrestrained commercial bank competition for savings, it really hurts the mortgage market. We have always been in the mortgage market, year in and year out.

We kept our lending volume up in the first 3 or 4 months of this year, but now with money being drained away from us and invested by commercial banks in short-term business loans, consumer loans, buying tax-exempt securities, I think it is a question Congress has to establish some kind of priorities in the use of funds and not let it just go to whomever can pay the highest rate.

Mr. ANNUNZIO. You do not have to be an expert in economics to understand that when young people go out to buy a home, and they have the downpayment, and if they cannot make a loan, that this is going to hurt the savings and loan. It is going to hurt the building industry, it is going to hurt many of the people who are employed in the building industry and this situation will spiral, the ball begins to get larger and larger and all of us are aware of the fact that we are in a very tight money market.

I want to ask this question, pursuing the responsibilities of the Federal Reserve Board. I feel that they are the key to this particular crisis for the simple reason that they created it and having had the power to create it, it seems to me, that under the regulations they can solve it. Since they are separate from us in the Congress, they ought to be able, if 2 weeks after they issue the order they were cautioning the bankers and now it is 5 months later, I think the Chairman of that Board should call a meeting as soon as possible to do something about alleviating the situation. They caused it, they ought to do something about solving it.

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Mr. STRUNK. I am certain within their law they can.

Mr. ANNUNZIO. Thank you, Mr. Strunk.

The CHAIRMAN. Mr. Rees.

Mr. REES. Mr. Chairman, before I ask some questions, I would like to read from a memorandum from a leading savings and loan institution in Los Angeles, to give you an idea of what we are talking about, in terms of competition, and who is investing in savings and loan accounts and who is investing in CD's. In this institution, which approaches a billion dollars in deposits, we find that 53.7 percent of their deposits are in deposits of $9,000 and over. This is to emphasize that the great majority of money that is in savings and loan accounts is investor-type money, of people who use this type of investment and use a fair amount of money in terms of the investment. This institution, in the last quarter lost something like $19 million deposits and $15 million was in accounts at the $10,000 level. So we are not talking about people that have $200 or $300 accounts, we are talking about those who are invested up to $10,000 insurance levels.

There were several questions that I wanted to ask. One thing that shocked me is in your testimony, Mr. Sherbourne, where you said that the banks had increased their foreign loans from an average of $1 billion to $2.4 billion, during this period.

Mr. SHERBOURNE. That is correct. They increased them during each of the years 1961 to 1963 by a billion dollars and in 1964, the year in which regulation Q was changed, the banks increased foreign loans and investments by about $2.4 billion.

Mr. REES. I think that is shocking. We have been losing something like $3.4 billion a year in terms of our gold reserves. Much of that has been lost because of investments and expenditures we make in other countries. Because of that we have had to send families home that have been, in say, Europe with NATO forces. We have had to curtail a lot of things in other countries and here we find that the banks are now loaning $2.4 billion which is a direct call on our gold reserves and therefore have a direct relationship to the amount of currency in our economy. I think something should be done about that. This money is being taken out of the building market in some of our States and is being put in direct foreign investments.

Does the Federal Reserve Board under the law today set limits on all CD's in terms of the amount of CD's? For example, could the Federal Reserve Board by rule say that all CD's have to be, say, at least $10,000 and must have a fixed date of maturity and fixed interest rate?

Mr. SHERBOURNE. The general counsel informs me that he doesn't think they have that legal power, to set a minimum amount.

Mr. MCKENNA. There is a difference of opinion apparently among lawyers on this, so I don't want to say it as a categorical answer.

My own opinion is that they would need the blessing of some further statutory provisions before they could set a floor under the amount of CD's.

Mr. REES. So we really can help the Fed if we wanted to by giving them this power?

Mr. MCKENNA. Yes, you could.

Mr. REES. Have we asked for the power, Mr. Chairman?

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The CHAIRMAN. No; we haven't asked for the power. I do not believe that the CD's are legal anyway. I would not be in a position to discuss that part of it, personally.

They had a secret meeting this morning. We have two Governments here in Washington, one run secretly, involving all credit, money, interest rates, and the Congress has the rest. We think they had such a meeting. We are not even sure of that.

Mr. REES. Do you not think there is a danger in the use of CD's? We found that in California, and I think in other parts of the country this last year or so, some banks—these are primarily new and small banks—have had to go into a forced merger because they had too many outstanding CD's and all of them matured just about the same time and therefore they were not able to pay the people that wanted to draw their savings. I think San Francisco National, Mr. Silverthorne's bank, was an example of this. Do you think it might be prudent to help the banks? I think we want to help them as much as anybody else, that we put in a provision as to what percentage of their full deposits can be invested in CD's.

Mr. SHERBOURNE. I certainly do, Mr. Congressman. With respect to our business, the Congress generally can, upon the recommendation of the Federal Home Loan Bank Board. Frequently whenever you permit us to go into a new area of lending, for example, you have the requirements of not more than 2 or 3 percent in a given area. So that the Congress had an opportunity therefore to test the impact of that new power and precisely that is what should have happened in this area.

May I emphasize again this point, that when you are paying 5¼ percent or 5 percent on 30-day money, that 30-day money is so close to demand deposits on which by law the commercial banks can pay no interest, in effect you are almost getting close to infringing a principle established by the Congress that it is unsound to permit this. But when you are paying 5¼ percent on 30-day money, you are almost doing just that. And the thing that has made it so volatile and so dangerous is that in effect corporations are getting a long-term interest rate on negotiable certificates which is almost like currency, because it is so mobile. This is an acute problem.

Mr. McKENNA. In answer to your request, Congressman, I quoted yesterday from an article by Mr. Herbert Prochnow, Jr., attorney for the First National Bank of Chicago. It seems he has been anticipating some of the questions to be asked by this committee and he was writing in November 1965.

On page 958 of the "Banking Law Journal" for November 1965, he said, "Traditional regulatory tests for capital adequacy may also be outmoded by bank issuance of capital debentures and promissory notes. The failure of some U.S. banks in part because of overreliance on certificates of deposit may indicate a need for a study of the maximum of percentage of deposits of an individual bank which should be derived from the issuance of time certificates."

Mr. REES. Thank you.

The CHAIRMAN. Mr. Hanna.

Mr. HANNA. I was not here at the time my name was called.

The CHAIRMAN. We are coming back to you right now. Mrs. Dwyer is entitled to recognition. She was not here the other day,

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yesterday, and then we will start right here with Mr. Reuss and Mr. St Germain and others who have not interrogated the witnesses.

Mrs. Dwyer?

Mrs. DWYER. Thank you, Mr. Chairman. I am sorry I was not here yesterday because I would have liked to have had the privilege of introducing Mr. Sherbourne to the committee. He happens to live in my district and is one of the most outstanding men in the savings and loan industry.

I read your statement last night, Mr. Sherbourne, and I congratulate you on it being a very, very constructive statement.

Thank you. I have no questions.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Mr. St Germain and I will yield to Mr. Hanna.

Mr. HANNA. I want to thank my colleagues. I want to thank the chairman for his courtesy.

Gentlemen, I wanted to go back to a point that was made by Mr. Rees about the distinction in the money that we are talking about when we are talking about the thrift savings and when we talk about the investors' deposits.

Now, I think this is a very important distinction to be made, particularly as a Californian, there is a distinction to be made and I would like to make it in the light of an understanding of what you said, Mr. Sherbourne, about the competitive position ordinarily as it has been historically—the banks and savings and loan institutions required that since the savings and loan does not give all the services that the bank does, that it has to have some spread in what it gives depositors. That has been examined into and and has been agreed.

I would like to point out one other point of spread. In California, because we were a State in which there was a greater demand for capital needs than there was capital in the State for this expansion, we became a capital importing State, therefore we had to give a little bit more than one-quarter in order to serve what our needs were and that was understood.

In addition to that we had a very aggressive group of savings and loan people. So they were able to take the two percentages, the one for the bank competition, the one for the importation of capital, allowing them to aggressively advertise for deposits. They are not now looking for local money to build local neighborhood buildings. They are now going out into the money market and they have become participants in the money market of the United States.

California has $26 billion of $130 billion of business and therefore about 20 percent of it. But during the period of time in which this importation of money was acquired, they did every year between 11 and 15 percent of the building that was being done in the United States. A business that ran from $45 to $60 or $65 billion a year. We were doing that in California and we needed the money to do it.

Now, any financial institution, be it bank, savings and loan or anything else, operates on liquidity for growth and if it is going to have new loans it has got to have new money input. Where does it get that money? It gets that money from its borrowing, from loans already made, it gets that money from its new deposits, and it gets that money from the returns from loans previously made, the paybacks.

Now, this is what happened in California. We got our first—we got ours with the large, the greatest market and we got the flow of

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funds in order to take care of the demands that were made for new loans out of all of this and we went rocking along fairly well with a few stumbling blocks in places like in 1954 and 1957 until we reached a period of time in which this all began and it was not in December of 1965, but it was when the insurance companies started pulling out of this picture in 1964. The red flag, as far as I was concerned, went up then. What happened there was everything had been made so fluid, that the money availability determined the building of homes and not the market needs, and so there was some overbuilding. That started the pullout. Now, at the same time, our national policy demanded for an expansion of our industrial capacity. Now, there began to be a slack off because of overbuilding in certain areas, there began to be a buildup of need for expansion of industrial potential and so a new pressure on the money market was developed and I understand that this last year, that something like $60 to $80 billion in business and industry expansion occurred. So it is understandable with this pressure on, it did not take very long to build in our country a flow of funds to banks. When the interest rate went up, this again contributed to the lack of inflow of funds. We found out in California that the demand for building is hedged upon the guy who is already in a new house—it is the moveup man that really makes the market. It is the man who is moving up in housing, and when the interest rate took his equity and ran it down again, he decided he would not sell.

So the raising of the interest rate changed the payoff. The 30-year loans had an average life of 7 years. And that meant there was somebody selling the house they were in to buy another house. Now, that has stopped. That has stopped. Because the man who had the house to sell found out if he sold under these new interest rates he had to take a discount on his mortgage that operated to be about a thousand to $1,200 on a $20,000 house. He decided he couldn't afford to put that much equity down the drain and he would not sell, he would hold on to it.

Now, what happens to the liquidity which was in this money that we were importing? There were no loyalties in that money. No loyalties whatsoever. This was investment money and it is looking for yield and returns. So when they found that the pressure had set up the interest rates, and the Fed with raising regulation Q opened the valve for the business expansion and provided the conduits, the CD through which that can flow, the money hit the conduits toward the banks. Then something else hit the fan for the savings and loans. And that is where we are right now and the CD's position in this thing is that it was a conduit through which this money could flow to meet the yield and the pressure that built the yield for construction loans. That is the way I see the picture and that is the way I see the CD operating in it.

I think that you can always have too much of a good thing and that is what we got in a CD. It was a good thing and we got too much of a good thing because instead of handling a reasonable relationship between the function it was supposed to fulfill and the fact that it starts hitting even down into the thrift level, it is even destroying the loyalty depositors, not only housing, not only lousing up the liquidity, and if I am not wrong, that is a good part of the picture as far as my own State is concerned.

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Mr. STRUNK. I might say, Mr. Congressman, you have painted a brilliant and accurate picture as far as I can tell.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. There has been much testimony both from you gentlemen and from many of us here stating the effects of the Fed's performance on CD's on home loans and homebuilding generally, which is the function of our savings and loan institutions.

At the hearings of the Joint Economic Committee right after the December action by the Fed on regulation Q, I asked Chairman Martin whether prior to the drastic change in regulation Q, which the Board instituted, he had consulted with or conferred with the Federal Home Loan Bank Board and his answer was no, he had not. Do you have any judgment, Mr. Strunk, as to whether that was in the interest of good and orderly Government, to effect this kind of change in the rate of our savings institutions without such consultation?

Mr. STRUNK. Mr. Congressman, I was quite amazed when I learned on the record that the Federal Reserve people had not talked with or consulted the Federal Home Loan Bank people and I would hope that they have opened up avenues of constant communication in the meantime because the Fed, I don't think should be taking actions, affecting something so vitally—something so vitally affecting the savings and loan business without talking to those people in Government who are responsible for the orderly conduct of the savings and loan business.

Mr. REUSS. Both in your testimony, Mr. Strunk, and that of Mr. Sherbourne, you have made specific suggestions for action with respect to certificates of deposit. Neither of you have, in terms, endorsed the bill, H.R. 14026, which would make illegal negotiable certificates of deposit, but both of you suggested changes be made. I myself have been greatly concerned with an aspect of CD's which has not been touched on this morning, namely, that they bear a 4-percent reserve requirement on the bank system as opposed to the 16-percent reserve requirement for demand deposits. A negotiable CD is about as close to a demand deposit as can be imagined. Do any of you have an opinion as to whether a raising of the reserve requirements from its present 4 percent would not take some of the gloss and bloom off of CD's and make them less irresistible to the large banks, an irresistibility which has contributed to the fact that we have now $17.5 billion worth of these pieces of paper?

Mr. SHERBOURNE. I think your comments are much to the point. I don't believe that setting a reserve requirement on the short-term CD's to be the same as on the demand deposits would cure the major problem. It would have a desirable impact because at the present time if a commercial bank were willing to let a proportion of these time deposits and negotiable certificates drift away, by remaining perhaps or taking a chance on their being converted to demand deposits, then they are put in the position of adding 8 percent to their reserve balance in the Reserve bank and that would be a little tough on them.

Mr. REUSS. So it is your judgment that no action should be taken to increase the reserve requirements on CD's, negotiable CD's?

Mr. SHERBOURNE. I don't think it would solve the problem, but I think it would be a desirable act.

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Mr. STRUNK. I would not say that the Fed should not take such action. I would hope that the Fed would. I would agree with you that this is something that—another thing that can be done about this problem.

Mr. SHERBOURNE. It wouldn't solve the problem as far as we are concerned.

Mr. STRUNK. No, it would not.

Mr. REUSS. Would it not, by damping down the attractiveness of CD's contribute to the solution of your problems?

Mr. STRUNK. It would I think contribute to the solution of it. It would not necessarily solve it.

Mr. REUSS. Do you agree, Mr. Sherbourne?

Mr. SHERBOURNE. The difficulty I face in answering that problem—it would affect it, but I think primarily the problem is this—if a commercial bank is enabled to pay a very high rate on a short-term deposit, it perhaps is willing to take the chance, even if they had to put up a 12-percent reserve instead of 8—they still have a substantial amount of additional deposits which they would use.

Mr. REUSS. What you are saying is that while it would not cure the problem, it might ameliorate it somewhat?

Mr. SHERBOURNE. It might ameliorate it, but not sufficiently for me to say there would be no residual problem of substantial magnitude left. I think the problem would still be there, but it would be a smaller problem, but still serious.

Mr. STRUNK. The CD problem might be approached in this manner, but it also needs to be attacked head on.

Mr. REUSS. Could it be attacked in both ways?

Mr. SHERBOURNE. Yes.

Mr. STRUNK. It could.

Mr. REUSS. During these same hearings in December, and again in a floor speech I made last January, I urged the Federal Reserve in its annual report, which I hoped to have in my hand by February 1 in the joint committee hearings, to give us its philosophical explanation of its performance on its regulation Q and CD's generally. Unfortunately, the Federal Reserve's report was not delivered to the House until 4 months after the start of the year, so that it was of no use in the Joint Economic Committee hearings this year.

I have had an opportunity to look through the report and I find in it, unfortunately, no real discussion of the certificate of deposit. Have any of you gentlemen had a chance to look at it?

Mr. SHERBOURNE. No, sir.

Mr. STRUNK. No, I haven't, sir. The certificate of deposit area has been so new that I think the Fed or other banking agencies have not really done much in the way of study in collection of statistics. We are handicapped constantly in looking at banks because of the inadequacy of them—in completeness of them. The Fed publishes data with respect to reporting member banks in leading cities, but that is only part of the banking system.

Now, the Fed in December for the first time got some facts. Those facts were released a few weeks ago and I think we were in—they were in the latest Federal Reserve Bulletin. This is the only area. I don't think the Fed has gotten enough data nor have they done enough—nor have they done much real thinking, I think, in this brand new banking area.

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Mr. REUSS. I would like to address a question to my colleagues in the lower tier, indicating that they are closer to the people than some of us older members. Have any of you gentlemen received the annual report of the Federal Reserve System?

Mr. REES. Yes.

Mr. TODD. I just got it. I received it yesterday.

Mr. OTTINGER. I have not received it.

Mr. REUSS. I would like to ask—I have not received it either, so this is not confined to you.

The CHAIRMAN. It will be furnished to all the members.

Mr. REUSS. If I may address my remarks to our friend, Bob Cardon, I think it would be a good idea if the Fed made available to each member of the Banking and Currency Committee a copy of this.

The CHAIRMAN. They should send each member a copy. They sent the chairman one.

Mr. REES. They send one to the chairman and the lowest member of the committee.

Mr. REUSS. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. I have a question for Mr. McKenna whom we all have a good deal of respect for.

In your opinion, does the committee have the power to legislate in the area that Mr. Rees brought up as to the amount of CD's that a bank can issue, in other words, to restrict the percentage of CD's as against deposits that the banks can issue?

Mr. MCKENNA. As to the Federal Reserve Board's existing power, we have not researched that and I would have to draw on my general knowledge of the Federal Reserve Act. It seems to me that this is in an area that would be within the cognizance of the Federal Reserve Board. It is a matter of supervisory importance and I would think that they would have, in that area, a field they could regulate if they chose to do so. However, I would appreciate the privilege of supplementing my opinion in the record.

(The following information was submitted for the record:)

STATEMENT OF WILLIAM F. MCKENNA

Representative St Germain raised the question of regulatory action to control the percentage of certificates of deposit issuable by a bank compared to its total deposits.

Mr. St Germain's specific question involved the authority of the Congress to establish such control by legislative action.

Article I, Section 8, Clause 5 of the Constitution of the United States empowers the Congress "to coin money, regulate the value thereof, and of foreign coin * * *".

U.S. Supreme Court cases interpreting this constitutional grant of power have sometimes involved notes issued by commercial banks, usually payable on demand, and backed by gold or silver. In the 1869 case of *Veazie Bank* v. *Fenno*. 75 U.S. 533, a challenge was hurled at the constitutionality of a Federal tax of 10 per cent levied on any bank that paid out State-chartered bank notes after July 1, 1866. The National Bank Act of 1863 had at that time established a system whereby national banks could issue engraved notes in an amount equal to 90 per cent of the par value of U.S. government bonds purchased by the bank and deposited with the U.S. Treasury.

In sustaining the constitutionality of the tax, Chief Justice Chase in the majority opinion noted:

"Having thus, in the exercise of its undisputed constitutional powers, undertaken to provide a currency for the whole country, it cannot be questioned that Congress may, constitutionally, secure the benefit of it to the people—Congress

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may restrain, by suitable enactments, the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile." 75 U.S. 548–549.

Commenting on the statute designed to force the withdrawal of State bank notes from circulation, Senator John Sherman gave voice to the truism that the volume of currency affects the price of commodities. Consequently in order to regulate the value of coin, it is appropriate for the Congress to control the volume and use of currency.

Certificates of deposit issued by banks likewise have a relationship to the value of money that warrants Congressional control of the terms upon and amounts in which such certificates may be issued. The kinship of such certificates to money is particularly close if they are issued in negotiable form, so that they can pass from hand to hand in lieu of the deposit of money they evidence.

The entire outstandings of certificates of deposit, whether negotiable or nonnegotiable, exert influence on the value of coin from another direction. Such certificates constitute an obligation on the issuing bank to pay the amount due on them at specified maturity dates. In our present financial system, the availability of deposits in financial institutions affects the supply of funds available for financial transactions through bank loans. This in turn affects the price of commodities, goods and services in the same manner as the volume of State bank notes affected the price of commodities. In extremes, unwise overissuance of certificates of deposit could result in the inability of the issuing bank to pay the obligation incurred at maturity, leading to failure of the bank due to insolvency. While it may be a matter of degree, one need only recall the economic situation in the United States in the early 1930's to realize that bank failures in turn affect the value of money.

In 1924, Mr. Justice Holmes speaking for the U.S. Supreme Court in the case of State of Missouri v. Duncan, 265 U.S. 17, upheld the authority of the Congress to sustain the competitive ability of its creature, the national bank, vis-a-vis State-chartered financial institutions. That case overturned a Missouri probate court's refusal to appoint a national bank as an executor under a will, even though the bank met the qualifications of a Federal law that authorized national banks to act as trust companies if like activity is carried on by State-chartered banks and trust companies. The question at issue is whether a State could impose a safeguard such as the deposit of securities to protect beneficiaries that a national bank could not meet under its enabling statute. In his decision, Justice Holmes stated:

"the State cannot lay hold of its general administration to deprive national banks of their power to compete that Congress is authorized to sustain." 265 U.S. 24.

Seven years earlier, in First National Bank v. Union Trust Company, 244 U.S. 416, the Supreme Court relied on the argument that business practice provided a connection between banking and trust business, thus sustaining Congressional authority to permit national banks to engage in trust activity if no contravention of local law was involved.

Thus the principle seems well established that the Congress can use the bridge of business practice to justify action to enable its financial creatures to remain competitive. This principle would seem easily to allay any doubt that the Congress can take similar appropriate action to sustain the competitive ability of its creatures that are Federal savings and loan associations, where competitive ability is drawn into the picture through the business practice of banks in issuing certificates of deposit.

The foregoing brief analysis has not dipped into the possibility of using the power of the Congress to regulate commerce with foreign nations and among the several States as a foundation for appropriate Congressional action controlling the terms and amount of issuance of certificates of deposits by banks. However, the Constitutional grant of power to the Congress to regulate commerce, as it appears in Article I, Section 8, Clause 3, may well supply an added basis for Congressional action with reference to certificates of deposit. In modern business practice, the actual transaction of making a bank deposit often flows across State lines, as does subsequent negotiation and transfer of a certificate of deposit issued by a bank as the result of the deposit transaction.

Let us turn now to the question as to whether the Federal Reserve System already possesses authority to regulate the percentage of total deposits in a member bank of that System that can be represented by certificates of deposit.

The Chairman of the Board of Governors of the Federal Reserve System strongly intimated that the System already has such authority. In his appearance

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before the Permanent Subcommittee on Investigations of the U. S. Senate Committee on Government Operations on March 16, 1965 in connection with an investigation into Federally insured banks, Chairman William McC. Martin, Jr., stated that the proportion of a bank's certificates of deposit to its total deposits is something that the System watches all the time. (Hearings, Part I, page 224).

In a colloquy with Chairman McClellan of the Subcommittee, Mr. Martin described "volatile" certificates of deposit as those taken by a corporation seeking an interest return on funds expected to be used for some corporate purpose within a short time. At the given time, the corporation either withdraws its deposit or sells its certificate of deposit if it is negotiable in form. Senator McClellan drew a distinction between a certificate of deposit likely to be withdrawn at maturity and a savings account likely to grow in size.

Mr. Martin noted that the hazards in issuing certificates of deposit are intensified if the issuing bank is relatively small or newly chartered. He stated that such a bank may have a ready market for its certificates of deposit one day and none whatever the next, and unless it has maintained proper liquidity and soundness on its assets, it cannot pay its "volatile CD's" as they fall due.

Senator McClellan then stated:

"If you are concerned or interested in the soundness of a bank, particularly a new one just starting, you would not take $10 million deposits for face value as sound growth. You would go back and examine to see how many of its deposits were similar to those volatile CD's?"

Chairman Martin replied: "Exactly."

Senator McClellan continued:

"The bank might have $5 million of its deposits in that kind of deposits, and that would not indicate sound growth up to the $10 million rate?"

Mr. Martin replied: "Not at all." He and the Senator then agreed that such a set of circumstances might indicate a lack of a healthy situation."

Senator Curtis joined the discussion to comment:

"Well, to be quite frank about it, the CD has gotten to be almost evidence of borrowing on the part of the bank as contrasted to the bank being the custodian of deposits in the old tradition—."

Chairman Martin agreed with Senator Curtis' analysis, and added that with the increase in interest rates the Federal Reserve System has been concerned that this borrowing be in relationship to the sound investment of assets. (Hearings, Part I, pages 224 and 225).

Later in the same hearings, Chairman Martin commented:

"Questions regarding the soundness of CD activity of individual banks require analysis of the assets, liabilities, capital, and management skills of such banks. This is the kind of analysis that examiners typically apply. It is a continuing responsibility of the examination departments of the Federal Reserve banks. In most of the instances in which CD's have been abused, the practice has been symptomatic of generally now unsound activity in the bank. In other words, the bank with CD problems has usually had other problems, including unsound lending practices. * * * When an examination shows unsound conditions in a State member bank, the Reserve bank presents the facts to the executive officers and, if necessary, the directors. The purpose is to have the management of the bank recognize and carry out its responsibilities to operate the bank soundly. Solution of CD problems in such cases usually requires solution of related problems. Besides avoiding further expansion of volatile CD's, the bank's management must stop making unsound loans, and do everything possible to collect or strengthen any such loans already made. To the fullest extent practicable, the bank must collect, sell, or borrow on loans, where necessary to pay off maturing CD's. In troublesome situations the Reserve bank may examine the bank more frequently than once a year, and may request interim reports from the bank.

"The Federal Reserve Board has authority to terminate a State member bank's membership in the Federal Reserve System and its deposit insurance for unsafe or unsound practices. It also may remove an officer or director of a State member bank for continued violation of law or continued unsafe or unsound practices. These are drastic remedies and under the law can be invoked only by following carefully prescribed procedural safeguards. It best serves the public interest to use these sanctions only in extreme cases. Thus far it has not seemed appropriate to invoke them in any case involving CD problems in a State member bank.

"The Board is not now asking for increased authority to deal with these problems. Thus far we have been able to meet our responsibilities with the tools at hand.——

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"Our experience to date does not demonstrate any clear need in my judgment for legislation providing stricter controls over the marketing of certificates of deposit or over transfers of bank stock. I share your concern, however, over the potentialities for trouble in these areas. The Federal Reserve System stands ready to cooperate with your committee and with the other bank supervisory agencies in making sure that adequate safeguards are maintained to protect the public against unsound banking practices." (Hearings, Part I, pages 228–230)

It should be kept in mind that since Chairman Martin's testimony in March 1965, certificate of deposit problems have increased, particularly in view of the December 1965 increase in permissible interest rates under Regulation Q.

From the foregoing testimony, it appears that the Chairman of the Federal Reserve Board views any trouble with certificates of deposit as a phase of unsound banking operation. He readily concedes that unwise activity by a bank in issuing certificates of deposit can lead to unsound operation. The proportion of a bank's total deposits represented by certificates of deposit is an item the Federal Reserve System constantly watches, according to Chairman Martin. He agrees that too high a percentage may indicate unhealthy operation of the issuing bank. To date, the System seems to have relied upon the persuasive power of examiners to convince management in any affected bank to take remedial measures with reference to overissuance of certificates of deposit. Chairman Martin stated that as of March 16, 1965 (the date of his testimony), the System had not found it necessary to use its "drastic remedies" of terminating a bank's Federal Reserve System membership or terminating a bank's deposit insurance or removing a bank's officers or directors.

Chairman Martin's discussion indicates that at that time he viewed the certificate of deposit problem as containable under Federal Reserve watchdog procedures concerning unsound banking practice. He would then apparently have seen no need for singling out the certificate of deposit as the subject of a specific regulation by the Federal Reserve Board that would control the dollar percentage of total deposit in a given bank that could be represented by certificates of deposit.

Admittedly authority for such a regulation would not be well-based were it to rely on the power granted to the Federal Reserve Board in 12 U.S.C. 371b. That section of the Federal Reserve Act addresses itself principally to the permissible interest rate to be borne by time and savings deposits, conditions upon payment of a time deposit before maturity and waiver of any requirement of notice of withdrawal of savings deposits.

But the broad power of the Federal Reserve Board to take precautionary action to safeguard against unsound banking practices would seem to include the authority to regulate the deposit mix represented by certificates of deposit. While the certificate of deposit as an instrument may not be evil per se, Chairman Martin's testimony before the Senate Permanent Subcommittee on Investigations indicates that its presence in large percentages in a bank may well lead to hazards of unsound operation.

The breadth of the Federal Reserve System's general regulatory authority is borne out by the following comments of Mr. Justice Brennan in delivering the opinion of the U.S. Supreme Court in U.S. *v.* Philadelphia National Bank, 374 U.S. 321, 329 (1963):

"But perhaps the most effective weapon of federal regulation of banking is the broad visitatorial power of federal bank examiners. Whenever the agencies deem it necessary, they may order 'a thorough examination of all the affairs of the bank'. whether it be a member of the FRS or a nonmember insured bank. 12 U.S.C. §§ 325, 481, 483, 1820(b); 12 CFR § 42. Such examinations are frequent and intensive. In addition, the banks are required to furnish detailed periodic reports of their operations to the supervisory agencies. 12 U.S.C. §§ 161, 324, 1820(e). In this way the agencies maintain virtually a day-to-day surveillance of the American banking system. And should they discover unsound banking practices, they are equipped with a formidable array of sanctions. As a result of the existence of this panoply of sanctions, recommendations by the agencies concerning banking practices tend to be followed by bankers without the necessity of formal compliance proceedings. 1 Davis, Administrative Law (1958), § 4.04."

To date, the System seems to rely on examination as a tool to discover and persuade correction of unsound banking involving issuance of certificates of deposit. The power of the Federal Reserve Board to seek to prevent unsound banking by adopting a suitable regulation controlling the percentage of deposits a particular bank may have in certificates of deposit would appear to be within

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the Board's possession. But unless the Board's views have altered from those expressed by its Chairman on March 16, 1965, it seems very doubtful that the Board would voluntarily make use of the power to issue an appropriate regulation to meet the problems caused by certificates of deposit in some banks.

Mr. ST GERMAIN. Can the committee, Banking and Currency Committee, legislate in this area?

Mr. MCKENNA. The Congress has the power to regulate the value of and to coin money. I think you have plenary power in that respect.

Mr. ST GERMAIN. The banks are actually coining money, so to speak. In going over the testimony, one point was brought out, the fact that it is difficult for the savings and loan people and savings bank people to compete with this high interest rate because a great deal of our money is being repaid, as Mr. Hanna brought out, based on much lower rates of interest returned on mortgages outstanding. Now, I wonder if you gentlemen will agree, that it is very possible that this change over this rate made back in December and the change in regulation Q could well be reversed downward or changed downward at any time by the Federal Reserve Board within 6 months, a year or 2 years if conditions so warranted. That being the case and it seems to me that this is almost inevitable within a few years are we not, in essence, hurting the young family man with one or two children who cannot find an apartment to live in and is forced at this time to go out and buy a house and take out a mortgage at whatever rate of interest that is being demanded of him? Are not these the people, in the long run, who are going to be hurt by the action taken back in December 1965? I ask you to comment on that one.

Mr. STRUNK. Yes, higher interest rates have a major impact on a family buying a home and these people are hurt. We have always felt that it is one thing to raise the interest rates on major corporations, who borrow for shorter periods of time, and another thing to raise the interest rates on people who buy automobiles, and that loan is only there a short period of time. It is quite different from the interest rate on a mortgage loan that is there for 25 years and you raise that rate, say 5 percent to 6 percent or 5½ percent to 6 percent, then he pays that extra percentage point on a lot of money over a longer period of time. These are the people who are hurt the most by increases in interest rates on home loans.

Mr. SHERBOURNE. There is another factor. The interest rate is higher on mortgages today because we are trying to cut down the volume of applications to a point that we can handle with available mortgages. What happens in that kind of market is that the association naturally selects those loans with a higher downpayment and a greater safety factor and therefore the one that is hurt the most is the new family of a man without a large deposit to put as a downpayment on the loan. He is the one affected the most directly and to the greatest extent.

Mr. ST GERMAIN. In view of the fact that the action taken by the Fed in December last year has had such an enormous effect on the economy, I wonder about this—for instance, in some State legislatures when we are voting on money matters it is not a single majority vote that is required, but because of the importance of the budget to the economy of the State in many States in the legislature it is required that it be passed by a two-thirds vote rather than by a single majority.

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Looking at this action taken by the Fed, would it not seem justifiable that these gentlemen also be put in a position where more than a one vote majority is required on a step that is of such significance to the economy and perhaps a two-thirds plural vote, be necessary for such drastic action?

Mr. SHERBOURNE. That sounds like a very logical suggestion.

On the other hand, there may be occasions where the failure to act could be serious.

Mr. ST GERMAIN. Nothing further, Mr. Chairman.

Mr. CHAIRMAN. I believe we have all had the privilege of a first go around. How many members now would like to interrogate the witnesses further. Let us go off the record.

(Discussion off the record.)

The CHAIRMAN. May I please call your attention to the fact that after this decision by the Federal Reserve last December in defiance of the President of the United States to increase rates 37½ percent, the most meaningfully effective, rediscount rate from 4 to 4½ percent, and the time deposit interest rate from 4½ percent to 5½ percent. As chairman of the Joint Economic Committee, composed of Members of both the House and Senate, I called a hearing for December 13 to look into that and asked the members of the Federal Reserve Board to appear. We interrogated them, all the members of our committee. For the first time in my recollection, and I have only been around 38 years, we printed a cartoon in these hearings. It was Herblock's cartoon that appeared in the paper that morning, showing the President on a bicycle with Chairman Martin of the Federal Reserve Board on the same bicycle, one pumping in one direction and the other pumping in the opposite direction. That is the situation we faced at that time. In these hearings I think it was very conclusively shown that the reason these rates were raised was not for the purpose of helping the economy of the Nation at the time by fighting inflation real or imagined. Raising the rediscount rate one-half of 1 percent did not amount to much, although it is a signal for high interest rates all over the country. The Federal Reserve was hurting because a few banks were hurting. This sounds like a sordid story because it is a sordid story.

You know, when the monetary authorities decided that they wanted high interest rates back in 1960 and 1961, they decided that the best way to do that job would be to get these large sums held by corporate managers out of the weekly auction market for short-term Government securities. The corporations were keeping the rate down. They were in there every week buying billions in Government securities and that kept the interest rate down.

Well, of course, we passed a law about that time making the average rate on treasuries the rate that the agencies of the Government would have to pay. Well, of course, some of the money lenders did not like that because the short-term rate was low. These corporate funds bidding on the short-term securities kept the rate down. Now, if they could get them out of this bidding, then the short-term rates would have to go up. So the big banks devised the CD with the help of the Federal Reserve and started a race between short-term Government securities and CD's. CD's, negotiable CD's, are nothing more than interest-bearing currency. That is all it is. Of course, whenever

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they got them, they had an opportunity to buy CD's at 4 percent with these corporate funds and if they needed to pay taxes in the near future or distant future they could always get their money out of this. And they would get this enormous amount at 4 percent at that time. It was a great windfall. It was a bonus. They gladly ran in at 4½ percent. But their leaving the auction market caused the rate on the short-term Government securities to go up and they went up so fast that in December, when over $3 billion worth of CD's were coming due in December, and probably twice that much in January and February, they were hurting. They could see they could not renew the CD's because the Treasury securities were more attractive. They would be ruined.

Then of course, the banks said: "You've got to get us out of this. We cannot keep these CD's at 4½ percent," and they had a meeting. They defied the President down at Johnson City, Tex., when they went down and told him, we have decided anyway, although you are against us, to raise the CD rate from 4 percent to 5½ and they went ahead and did it.

Now, here is the trouble, folks. We are just spinning our wheels around here. We are letting the Federal Reserve run over Congress and run over the country. They are running the major part of our Government. They have taken it over. They have seized it just like Castro seized Cuba. They have taken it over. They do not have the power to do it, but they have done it anyway. And the reason they could do it is because they do not have to come to Congress for appropriations. You see, all other important agencies of Government have to come to Congress to get their appropriations to run their organization. And in getting that they must make certain disclosures. What are you going to do with this money? How are you going to handle it? In that way the Constitution contemplated that Congress elected by the people would have charge of all agencies. And of course the Federal Reserve got away from Congress because they were able to take the Federal Reserve currency and trade it for Government obligations.

Now, remember, they are fiscal agents of the Government and they are supposed to look after the Government's business. If you had a mortgage on your home of a thousand dollars and you gave your agent—we will call him a fiscal agent—a thousand-dollar check to pay that mortgage and he takes it, pays the mortgage off all right, but he has the mortgage transferred to him instead of you, and the mortgage is not canceled—he wants you to pay interest every time there is an interest payment and when it comes due he would want you to pay it again—you would not think that he was a very good fiscal agent. That is what the Federal Reserve has been doing for years. They have been taking the people's money, trading for U.S. Government bonds, keeping the bonds and requiring the U.S. Treasury to require the taxpayers to pay interest on those same bonds. They are getting a billion and a half dollars a year interest and they can spend that money any way they want to. As evidence of it they are actually joining the American Bankers Association every year. They pay tens of thousands of dollars as dues and donations to the American Bankers Association and State bankers association, aggregating a hundred thousand dollars a year. That is public money.

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They are taking our public money, becoming dues paying and card carrying members of the American Bankers Association. That is what they are doing. That shows they can spend money for any purpose. That is right. I can bring up illustrations just as ridiculous. It shows they have defied the Congress. They say they will use any part of this billion and a half dollars for any purpose, any purpose they want to and it would really shock you if I told you what they used this money for.

They have defied the Congress and defied the country. They have use of this billion and a half dollars any way they want, and what is left goes into the U.S. Treasury. Any of it that is paid out for these purposes would otherwise go into the Treasury. It shows that they are not looking to Congress because they do not have to get their money from Congress.

Another thing, they are not audited by the General Accounting Office like other Federal agencies. So what are you going to do with a bunch like that who shake their fist saying we defy the President of the United States and the Congress? How can our Government last when the elected representatives have such limited responsibility and such limited powers compared to the greatest powers exercised by a few people in the banking system who absolutely control the Federal Reserve. The Federal Reserve has a meeting down there this morning on Constitution Avenue. It is a secret meeting. They have their guards around it. Hitler never guarded a building in his life as well as they guard that building down there. They keep everybody out. They do not want anybody around there except the ones they want.

The truth is the Federal Reserve Open Market Committee is composed of 12 members by law. The law says that. Seven public members are supposed to be on it and five are the presidents of the Federal Reserve banks. Of course, those presidents of the 12 Federal Reserve banks are elected by the private banks. Because the private bankers select a majority of the bank directors, they are right in there and not only do the seven members of the Board come in this secret room down there so highly guarded this morning that I doubt if the U.S. Army could get in there, but they also let the five presidents come in and then they let the other seven presidents come in. When they do that they operate in violation of the law.

Down in the Southwest when people operate outside of the law, we call them outlaws. I would not want to call them outlaws because I know they do not intend to go to that extent, they are not the type. They are not revolutionaries or anything like that. But in effect they are violating the law. They have some 20 to 30 or 40 staff people there and then they go back and make these decisions. You will not know their decision for 5 or 6 years. It will be 5 or 6 years before that information will be out. They want to keep it secret. But they go back and report to their respective Federal Reserve banks, each one has a board of directors, six of nine directors elected by private bankers with different connections over their respective districts. I estimate that at least 500 people know instantly what is happening in the secret session over the Nation. They know how to cut through this. What chance have the others got? They use loaded dice. They know what the score is. So that is going on right here in the United States of America in broad daylight. You would never think it would happen,

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but it is happening here; yet, we do not deal with it. Why will not Congress deal with it? They look upon monetary values as sort of sacrosanct, hallowed ground, leave it alone, let the bankers do it because they know all about money, when they really do not. All they do is to go out and make loans and how to collect it back, and this is necessary for the economy. But they do not know the science of money and do not claim to know.

They are not looking after the public interest as you would expect them to look after their own interests. We all do it. It is perfectly natural.

But as long as we are permitting this to go on, we in Congress are just spinning our wheels. We do not have the main powers. We have let them take them away from us. They are not right in this independence. Because the Constitution is too plain on it. We do not have four branches of the Government. They are claiming to be the fourth branch of the Government—the legislative, executive, judicial, and Federal Reserve. Well, we do not have that in the Constitution. It is an agency just like any other agency, subject to the will of the elected representatives of the people. That is what they are.

Now, how long are we going to put up with this? It is a serious question. They have the advantage of us. They got all this money, they've got $40 billion in the Federal Reserve Bank in New York and the people know that. It is in U.S. Government bonds, interest bearing. They belong to the people. Yet the Federal Reserve claims it belongs to them. They can do anything with this money just like they pay dues to the American Bankers Association. They spend this money any way they want to. Would that not be a huge campaign fund? That is exactly what they are doing. You could not stop them. They defy us. They are not responsive to us. They are unelected representatives of the large Wall Street banks.

Now, if the elected representatives of the people were doing that they could be defeated. They could be punished. That is what the Constitution contemplates, if somebody in responsibility does this. It has gotten out of hand. What are we going to do about that?

Mr. ANNUNZIO. Would the Chairman yield? You have illustrated the meeting in Johnson City, Tex., when they went down to meet the President of the United States and after the meeting with the President of the United States they still went ahead and raised the discount rate to 4½ percent. So they have proven your case.

The CHAIRMAN. To bail out a half dozen banks. I want to invite your attention to these hearings and you can get them from the clerk. We have 200 copies. I knew this was coming up.

This volume here has the testimony of all the Federal Reserve Board members and it bears out what I have said. Nobody disputes what I have said. Nobody disputes it. Volume No. 2 contains valuable information, too. So every one of you who wants a copy of these hearings, just ask the clerk to let you have them. You will be astounded to know some of the things that are absolutely undisputed. Everybody knows.

It is like this $40 billion in bonds. We could reduce the national debt $40 billion. Why should we pay our debts twice? Nobody can answer that. I have asked Mr. Martin that, I have asked Mr. Eccles when he was Chairman—I asked the others, but I cannot get any atten-

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tion on things like that. But we have reached a crisis here. We have reached an impasse. We have reached a point where they are using this power to destroy the institutions that have built more homes in America than any other financial institution on earth. They are putting you out of business. You cannot possibly survive if the Federal Reserve has its way. Now, if they have the power at all to permit CD's, they should certainly limit them.

But, in the first place, they do not have the power to do it. They know that. Therefore, they are not limiting the CD's. They are strictly illegal, it is wrong and something should be done about the Federal Reserve. Our Government cannot continue on indefinitely that way. Because the Wall Street bankers have charge of a principal part of our Government—the amount of money we have in circulation and the interest rates.

There is a book, "Primer on Money" that shows interest rates on long-term U.S. Government bonds for 75 years. There was a period of 12 years of the roughest time in American history, from the early part of 1939 to the early part of 1951, month by month, when interest on United States bonds never went above 2½ percent and if people wanted their money, they could get their money quickly with accrued interest and at par, no doubt about that.

Now, if the Federal Reserve acting then as public servants, and I will say this for Mr. Eccles, Mr. Eccles' monetary beliefs were very much the other way, but when he was on the Federal Reserve Board, he felt his duty as a good patriot, a good patriotic citizen to cooperate with the people's elected officials. And he did cooperate. And during that 12 years we had unemployment up to 10, 15 million people, we had breadlines for blocks, breadlines in the principal cities of America and we would have people trying to sell homes and farms and the sheriff would be stopped by mobs saying you cannot do that to our neighbor, we had food stores being raided all over the United States, we had terrible times then. But then the war came and we had employment, people saved money, they wanted to buy something with it. They could not buy automobiles, appliances, or scarce materials like that. So they had a lot of money, a lot of money pursuing a small amount of goods. That was tailormade for inflation.

We were shooting a quarter of a billion dollars away on the battlefields. The most potentially inflationary time in all history. Yet, during the 12 years with all those bad debts and inflationary situation, the Federal Reserve Board kept the interest rate less than 2½ percent on long-term bonds and they did it for more years than 12 and I will not go into that. If they could do it at that time they could do it any time. If they had done that ever since, we would be in a much better position. So we have got to do something about the Federal Reserve Board. If interest rates had been kept at 1952 levels, instead of going up since that time, we would have saved $60 billion in interest alone and our national debt would be way down. We are in an awful mess here with two Governments in the United States, one elected and responsible to the people—but limited with powers—and with another Government run by the New York banks, unelected, responsible to no one, paying no attention to anyone, selling mortgages on all the property of all the people every day at their will, earning interest on it—just footloose and fancy free. How

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long are we going to do that? We cannot do much about this until we do something about the Federal Reserve.

Shall we have these gentlemen back in the morning to pursue the matter?

Mr. Moorhead, did you have any questions?

Mr. MOORHEAD. I notice the testimony had to do with the liquidity crisis in December. Is there something in our economy that makes December a particularly vulnerable month? I remember in years past it used to occur earlier in the fall about the time of the harvest. Is there something about December that we should be concerned about?

Mr. STRUNK. December is always a time of huge demand for cash. I don't think there is anything unusual about December last year except that this was the time when the interest rates went up. The Fed did raise the rediscount rate and raising interest rates generally caused the so-called CD crisis because the banks had $3.5 billion of CD's maturing in December. But I think the banks have billions of CD's maturing every month.

Mr. MOORHEAD. Thank you, Mr. Chairman.

The CHAIRMAN. Who is next? Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman. Mr. Strunk, the chairman has pointed out that negotiable CD's are almost equivalent to interest-bearing money. This bill would really stop that practice, but I do not see that it would affect your position, because your position is affected apparently by savings deposits which are converted not into the negotiable, but into the nonnegotiable CD's. I was wondering if you had any comments relevant to this problem, because it would appear that although this bill would perhaps correct one situation we should not allow to continue, it would not solve the situation with which you are faced.

Mr. STRUNK. That is correct. As we pointed out in these hearings, there are two kinds of CD problems. One relating to thrift institutions and one relating to the money market and banking in general. We are more directly concerned with the nonnegotiable or what we call the consumer CD.

Mr. TODD. Mr. Ottinger's proposal would address itself to a solution of your problem, but it would do so by really separating money into two different markets, one market for the small depositor and the other market for the large depositor who would still be able to buy the CD and you would set up essentially two different interest rates.

Mr. STRUNK. You are correct.

Mr. TODD. So we would be doing what you mentioned earlier, we would be passing judgment on the competitive positions of the financial institutions which we prefer to avoid, but under the circumstances I do not see how we can avoid it.

Mr. STRUNK. You have got to be concerned with the flows of funds in the various phases of the economy and I think there will be a great shortage of funds of mortgage money. It is in this area that you must be concerned.

Mr. SHERBOURNE. The only concern that I have with the situation that I point out is that it was the tremendous buildup in negotiable certificates that created this problem that finally led the banks to burst over into the consumer type of CD at rates that were higher,

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much higher than were paid on savings. So that if you simply controlled the consumer CD as Mr. Ottinger suggested and did nothing about the negotiable CD, I think you would still have that problem spill over into some other area that would create a condition for our industry and problems for our industry.

Mr. STRUNK. These things are never simple.

Mr. TODD. We can change the Reserve requirements against CD's or something like this. Thank you.

The CHAIRMAN. Mr. Ottinger.

Mr. OTTINGER. Mr. Chairman, I would like to address myself to the problem that the chairman has raised, that if we put a $15,000 or some other limit on all CD's rather than outlawing them completely, we would be discriminating against the small investor. He could get presumably only 4 percent, which is the limit on present passbook savings rather than the 5½ percent the larger corporations are getting through CD's.

Cannot the big investor get 5½ percent elsewhere on his money?

Mr. SHERBOURNE. Yes, he can.

Mr. OTTINGER. So there will still be that discrimination regardless of the regulations that we might place on the CD's. The large fellow with the tremendous drawing power that he has can always invest in quite a variety of different markets with different kinds of paper and get high interest rates.

Mr. STRUNK. The large investor always has advantages over the small investors for a large variety of reasons.

Mr. OTTINGER. Is there a way of resolving this problem by either requiring the interest rate to be reduced on CD's or requiring that the 4 percent be raised on passbook accounts? It is feasible to establish a regulation that would increase the passbook accounts of 5½ percent? Could your institutions afford to pay that kind of interest?

Mr. STRUNK. Not today, sir. After all, our money is invested in mortgages that pay a little more than 5½ percent. You cannot get more interest out of existing mortgages. I am not sure what this would do to the financial integrity of the banking system and savings and loan system to be constantly paying higher interest rates for money. If that were to happen we would have to charge considerably more on our new loans, you see. So I think you have to consider just how much financial institutions can afford to pay and what are prudent rates of interest to pay for other's money which you invest in mortgage loans, you see.

Mr. SHERBOURNE. If the rate on savings accounts, the permissible rate under regulation Q, were raised to 5 or 5½ percent, the drain would be even worse than we are now experiencing from the consumer CD's.

Mr. OTTINGER. That is what I wanted to make clear that this was not an available solution at all. Also, that we are not discriminating against the small investor by putting a limitation on the consumer CD's, but we are merely reflecting a situation that already exists, regardless of anything that we do. This large investor has the power in the present market to pull down his 5½ percent regardless of whether it is in CD's or other types of finance. By putting a floor on CD's we would be just eliminating a particular market in which

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the large investor is doing a great deal of damage. But we are not going to be creating any discrimination. That already exists.

Mr. SHERBOURNE. May I point out that the small men with $2,000 or $3,000 can now put that money into California savings and loans and receive a return of 4.8 and 5 percent so that therefore an immediate vehicle is already provided to take care of the small men. But you are now referring to the fact that perhaps this situation doesn't permit commercial banks to do it, because they can only pay 4 percent on regular savings and this rate on negotiable CD's, this high rate is available only to the large man. From Congress' point of view, savings and loan associations provide that function, therefore you are not operating against the small man. If you were to restrict the commercial banks solely in the area of CD's you wouldn't restrict the potential return on savings for small investors.

Mr. WELTNER. Would the gentleman yield? Is California the only State wherein the associations are permitted to issue certificates of deposit?

Mr. STRUNK. Our institutions are permitted to issue a certificate, but it is not a certificate of deposit as practiced in commercial banking.

Mr. WELTNER. It is the same thing, though?

Mr. STRUNK. We promise to pay a quarter or a half percent more than the regular rate and it takes on some of the characteristics of a certificate.

Mr. WELTNER. Do you not call them CD's?

Mr. STRUNK. Our people do not call them CD's. They call them savings certificates.

Mr. WELTNER. SC's?

Mr. STRUNK. The Federal Home Loan Bank Board in December, in response, in great part to action by the Federal Reserve Board in regulation Q, the Board permitted federally chartered associations to issue a certificate. It is what we call a long-term fixed balance bonus account which is the technical term.

Now, in California, the Federal Home Loan Bank Board permits the associations there to pay as high as 5 percent on such certificates. In other parts of the country the Board's limit is 4¾ percent. The savings and loan associations all over the country can offer a 1-year certificate with a rate one-quarter point or half point above the base rate, but in no event more than 4¾ percent, but in California, because of the higher rates there and the problem of the banks there going to 5 percent, the Board in April permitted those institutions to pay as high as 5 percent, combined rate.

Mr. WELTNER. Are not the associations in other parts of the country petitioning the Board for authorization to issue certificates as high as 5 percent on $2,500 for 6 months?

Mr. STRUNK. You are correct.

Mr. WELTNER. Is not that the same thing as a CD? There is really no difference, in the mind of the public, or otherwise

Mr. SHERBOURNE. There is one difference in the impact. A corporation is not going to put up $500,000 in that type of certificate. It is not going to put that kind of money in a $150 million organization, but it will put it into a $2 or $3 billion bank because they realize the size of that institution is such that they don't have to be concerned about the fact that only $10,000 of that is insured.

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Mr. WELTNER. But your problem is with consumer CD's?

Mr. STRUNK. Yes, these certificates that the Federal Home Loan Bank Board has authorized to help us compete with the so-called consumer bank's CD.

Mr. WELTNER. That is the basis of the associations seeking authorization to compete with the consumer CD's authorized by banks?

Mr. STRUNK. Yes.

Mr. SHERBOURNE. That is being used mainly in California because of the problem, Congressman, described and pointed out earlier.

Mr. WELTNER. Thank you for yielding.

The CHAIRMAN. I think I should let it be known that we will expect the Chairman of the Federal Reserve Board to appear before our committee at a time that is satisfactory. I mentioned that to Mr. Multer and he suggested that we also have the other six members of the Board and I share his view. I think we should also alert the Presidents of the Federal Reserve banks who are in charge of the 12 district banks throughout the country that they will probably be needed, too, and to be ready to testify. Do you know of any others?

Mr. WELTNER. Mr. Chairman, what about asking Mr. Horne?

The CHAIRMAN. Yes, he will be here tomorrow. I think we should have Mr. Saxon and Mr. Randall because they also have a responsibility. We will also hear Secretary Fowler. Any other witnesses?

Mr. OTTINGER. The home builders are coming in. They are already scheduled.

The CHAIRMAN. Yes, they are. I am talking about the ones related to the CD's in a governmental capacity.

Mr. TODD. Mr. Chairman, I would just like to compliment the witnesses on the excellent testimony they have given. I think it is some of the best I have witnessed during my period of service on the committee.

Mr. OTTINGER. I agree with that, Mr. Chairman. I would like to say, also, that I agree with your concern over the way the Federal Reserve handled this matter and your concern over the whole certificate of deposit situation, but I think we have to exercise due caution not to disrupt the entire economy.

The CHAIRMAN. Certainly, we must. We do not want to do anything that would upset things. But CD's have had such a tremendous impact on the public that we must go into the matter thoroughly.

Mr. OTTINGER. I think in the longer course we are going to have to do something to see that the monetary policies of the various regulatory agencies are coordinated. While we may take a more limited action with respect to the immediate CD situation, I believe the larger issues you raise are of great long-term concern.

The CHAIRMAN. Who else? Mr. Annunzio?

Mr. Rees?

Mr. REES. I have enjoyed this testimony very much. I hope that this committee can do what Mr. Ottinger suggested. I think we have to eventually develop some type of coordination between these two types of institutions. This competition where at one time one institution is on top and then the other is on top can be destructive to our economy.

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The CHAIRMAN. We will recess until 10 o'clock tomorrow morning at which time we will have Mr. Horne.

(Whereupon, at 12:05 p.m. the committee adjourned, to reconvene at 10 a.m., Wednesday, May 11, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

WEDNESDAY, MAY 11, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, Ashley, Moorhead, Stephens, St Germain, Gonzalez, Minish, Weltner, Hanna, Grabowski, Gettys, Todd, McGrath, Hansen, Annunzio, Rees, Widnall, Fino, Mrs. Dwyer, Halpern, Harvey, Clawson, and Mize.

The Chairman. The committee will please come to order.

This morning the committee continues hearings on H.R. 14026 and related proposals concerning certificates of deposit.

Our witness is the Honorable John E. Horne, Chairman of the Federal Home Loan Bank Board. The Federal Home Loan Bank System was established by Congress in 1932 to provide reserve credits for savings and home-financing organizations. There are 12 regional Federal home loan banks located throughout the Nation in an organization similar to that of the Federal Reserve System. I might add his agency is a true arm of the Congress in that it is subject not only to a regular General Accounting Office audit, but also to congressional appropriation procedures. Another difference is that the Federal Reserve creates its own money while the home loan banks must go to the capital markets for their money just like a private borrower and pay whatever interest rate the market requires.

The Home Owners' Loan Act of 1933 provided for the establishment of a system of federally chartered savings and loan associations.

And in 1934, in order to further encourage and stimulate savings and investments in local thrift and home-financing institutions, Congress created the Federal Savings and Loan Insurance Corporation. This is a wholly owned instrumentality of the Government which insures savings in all Federal savings and loan associations and in qualifying State-chartered savings and loan associations up to $10,000 for each account. The purpose of Congress was to insure the safety of investment in these thrift and home-financing institutions and thus encourage a flow of funds for sound and economical home loans to fit the needs of the local community.

The Nation's insured savings and loan institutions must by law and regulation invest primarily all their assets in first mortgages on real estate. The people who have $130 billion invested in these thrift institutions thus depend upon a sound and prosperous housing market

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for their dividends. By the same token, homebuyers, homebuilders, and the entire housing and construction industry depend upon thrift institutions as a primary source of financing for them.

Our witness this morning is not only the top Government administrator of the thrift industry, but as we have seen he is a top housing man also, because it is his responsibility that we have an effective flow of funds into a sound savings and loan industry and into homebuilding. John Horne is an able and dedicated public servant and we know he can help the committee in assessing the impact of CD's on the thrift industry from the standpoint of the responsible Government official.

Mr. Horne, we are glad to have you and you may proceed in your own way. You may identify for the record the gentleman accompanying you.

STATEMENT OF HON. JOHN E. HORNE, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD; ACCOMPANIED BY DR. HARRY S. SCHWARTZ, ECONOMIST, FEDERAL HOME LOAN BANK BOARD

Mr. HORNE. Thank you very much, Mr. Chairman.

I do have with me Dr. Harry Schwartz who is the economist for the Federal Home Loan Bank Board.

The CHAIRMAN. Glad to have you, Dr. Schwartz.

Mr. HORNE. Mr. Chairman and members of the committee, I appreciate the opportunity to appear to testify on H.R. 14026 and H.R. 14422. I will try to answer any questions you may have after I finish my testimony. Our view of the certificate of deposit question reflects to a large extent our experience.

As we understand the certificate of deposit, it is one of two general types of instruments which banks may issue in addition to savings passbooks. Passbooks are limited to individuals and certain nonprofit charitable corporations. Typically, certificates of deposit and time deposits open account, the other nonsavings passbook instrument, were issued in large denominations to large depositors who did not qualify for a passbook. It has been reported that historically in the Midwest, some banks issued certificates in small denominations.

Sometimes the certificates were issued at the savings passbook rate and at other times a little higher rate to hold medium-size deposits when the savings passbook rate was below the regulatory ceiling. Time deposits at commercial banks, that is certificates and time deposits open account, have been in an upward trend since the close of World War II, with fluctuation in volume which were in the opposite direction from the change in rates on market instruments.

Since 1961, the increase in negotiable certificates of deposit has been quite large. Banks which report weekly have had an increase in negotiable CD's of $15 billion since the end of 1961 accounting for about 55 percent of the growth in time deposits other than savings. The widespread adoption in 1961 of negotiable certificates contributed to this upswing. The advantage of the negotiable certificate lies in the fact that the holder of the certificate can sell it. For example, a 1-year or 6-month certificate becomes, in effect, a very short-term instrument from the point of view of the depositor. Banks thought that this would permit them to compete more closely with commercial paper, Treasury bills, and other money market securities. We

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cannot tell the degree to which the growth in CD's reflects this type of development and the extent to which it may represent a shift from demand deposits within banks or from investment in time deposits open account.

In any event, with present rates that can be paid on nonnegotiable CD's and time deposits open account, banks might still be able to attract a very large amount of money without issuing negotiable CD's.

In fact, this is a problem which has confronted the savings institutions since early 1965. Because of the change in regulation Q in late 1964, it became possible for banks to pay more on CD's than they could pay on passbook savings. Some banks began issuing nonnegotiable CD's with multiple maturity dates, that is, a 5-year CD with maturity date every 90 days. These were called savings bonds or investment certificates. They were issued to yield 4½ percent while the savings passbook rate was 4 percent, and they were offered in denominations as small as $25 or even less.

Almost immediately, in areas where associations and savings banks were paying less than 4½ percent, there was a marked shift in the flow of savings when banks in the area offered this kind of instrument. Since last December, the problem has become particularly acute. Increasingly, in one area after another, banks have adopted either the savings bond device or a fairly short CD with automatic renewal in small denominations at rates above what thrift institutions are paying. We do not object to competition, but we do have some concern that the use of the certificate of deposit or even the time deposit open account device to circumvent the savings passbook rate ceilings can cause large shifts of funds from thrift institutions to banks in a way that was not intended.

As a matter of fact, if I recall correctly, Chairman Martin before the Joint Economic Committee stated that the Federal Reserve Board did not raise the 4 percent on passbook savings because it did not want to disturb unduly the savings in thrift institutions, but the point that I am making is that the CD's are being used in a manner which, in a way that circumvents the 4-percent passbook savings limit that is present and which is presently imposed on passbook savings in commercial banks.

In the first quarter, for example, net savings gained by savings and loan associations were off about 30 percent from the first quarter of 1965. In April, associations lost about $550 million in savings against a net outflow in April 1965 of less than $100 million. Interestingly enough, banks had about the same relative experience for total time and savings deposits in the first quarter as did savings associations. But in April, weekly reporting banks had a gain in time and savings deposits of $800 million, only $100 million less than April 1965. It is evident, too, that the losses experienced by savings and loan associations were greatest where banks were offering CD's in denominations of from $10,000 down to $25 with most banks engaging in these practices being below the $5,000 level and many at the $100 level or less. We can only assume that a good part of the loss in savings from thrift institutions in April went to banks.

This year, so far, the portion of time deposits excluding negotiable CD's of more than $100,000 has increased by more than $4 billion at weekly reporting member banks compared with a growth in large

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negotiable CD's of $1.4 billion. The nonnegotiable instruments grew more than 2.5 times as rapidly this year as last year and more than 5 times as rapidly as in 1964.

Again, we are not complaining about competition. We recognize, too, that if a shift in funds is desired by the marketplace, it should be accommodated, but we cannot help wondering whether we do not have an artificial device on our hands. The CD is permitting banks to pay a high rate on a portion of their savings in the disguised form of a time deposit, while paying a relatively low rate on regular savings. In effect, the CD which, apparently, was not intended for this purpose is being used to alter quite radically the structural relationship between thrift institutions and commercial banks. Mr. Guy Noyes, senior vice president of Morgan Guaranty Trust Co. and a former adviser to the Board of Governors of the Federal Reserve System, was quoted in last Friday's New York Times, as saying that if interest rates continue to rise, savings and loan associations and mutual savings banks may face a very sharply reduced savings inflow or may be unable to hold the savings they have. This latter condition seems to be in process already.

Some may argue that if banks are not permitted to pursue savings through the CD or time deposits open account device that they might be no better off than savings and loan or mutual savings banks. Therefore, it may be said, all a restriction on bank issuance of CD's would do is to reduce bank access to liquid funds and all financial institutions as a group would be no better off.

This argument seems to be a bit disingenuous. First, it appears to say that if there is a liquidity squeeze on banks they should be able to correct this squeeze by drawing funds by any devices from thrift institutions, and that it may be better for one set of institutions to take the pressure rather than passing it around. Since thrift institution portfolios liquidate fairly slowly, this places them in a very tight position and requires them to cut back very sharply on their lending with very severe effects on the mortgage market.

Second, banks being short- and medium-term lenders to a very great degree, they can adjust more quickly. Indeed, they need not increase their lending quite as sharply as they could if they drain very large blocks of funds from the thrift institutions.

In effect, banks are likely to cause thrift institutions to shrink so that they can expand their lending. This may not be inappropriate, if the process is clearly justified and does not threaten the structure of financial markets. But the instruments now being used to cause this shift raise some serious questions about justification and structural disturbance.

We, therefore, recommend that Congress grant authority to the appropriate bank regulatory agencies to set a minimum amount on certificates and on time deposits open account and we would like to emphasize both types or else a major loophole would exist.

Insofar as negotiability of CD's is involved, we think this is part of a broader question about CD's and time deposits open account in general. For example, nonnegotiable CD's and time deposits open account amount to about 75 percent of the increase in time deposits held by banks so far this year compared with less than 20 percent last year. We commend the committee for opening up this area to inquiry.

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The CD time deposit issue has several facets. First, by use of these devices banks attract very highly interest-sensitive money. They are building a liquidity squeeze for themselves if they pursue this too far.

Second, these instruments could bring about a misdirection in the flow of funds and resources. If banks continue to attract very short-term, highly volatile funds, and then generate an increased volume of credit, borrowers who typically deal with banks, such as corporations and users of consumer credit, may expand their spending exceedingly rapidly. While some resources can be transferred from sectors not receiving funds, we know very well that resources are not fully or always readily transferable. Severe bottlenecks could be generated because of purely temporary and perhaps speculative demand shifts, particularly in inventory accumulation and perhaps even plant and equipment.

Third, the present use of certificates of quite small denomination seems to be causing a very rapid structural shift among financial institutions which could have a highly unfavorable impact on the mortgage market. We are not arguing here that the mortgage market is sacrosanct and that it should not experience any reduction in available funds, but a cut of 50 percent or more for the remainder of this year, which now seems likely, is not justified and may, indeed, be disturbing to our economic structure. In other words, a shift in funds can proceed too rapidly for all concerned and may contribute to subsequent instability.

We would suggest examining the extent, in relation to total deposits, to which banks may use any of these instruments, negotiable CD's, nonnegotiable CD's, and time deposit open account. A minimum size limit for all these instruments and the appropriateness of multiple maturities and automatic renewal should also receive the committee's attention.

In closing I should like to make it clear that the concern we have is with the effect of the present situation on the structure of financial markets. While savings and loan associations dislike losing savings just as businessmen dislike losing sales, their soundness need not be affected thereby. The industry as a whole is sound.

It is not the saver in an insured savings and loan association who needs to be concerned. He can rest easy. I want to stress this because sometimes the savings public may misunderstand, and I think that a difficulty in one area impairs the safety of our savings accounts. This is not the case. Those accounts that are insured by the Federal Savings Insurance Corporation are safe and the saver can go to bed at night and rest in peace as far as whether or not his money is adequately protected. However, the present situation in savings flows promises to cut mortgage availability to perhaps intolerably low levels. Consequently, we believe that the issues before this committee should be explored thoroughly.

The CHAIRMAN. Thank you, Mr. Horne. You have presented a very interesting statement. Are you contending that this inflow of funds from thrift institutions to commercial banks is not only harmful to the mortgage market but that it is also inflationary?

Mr. HORNE. Well, so far as the mortgage market is concerned, Mr. Chairman, we know that during recent years the amount of homes financed by private thrift institutions, we mean primarily when we

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talk about thrift institutions the savings and loan associations and the mutual savings banks. But so far as savings and loan associations themselves are concerned, they have in recent years financed in excess of 40 percent of the residential construction.

Now, if the money does not flow into these associations as it has in the past, or if the money that is there flows out, then unquestionably it is going to affect the availability of money available for homebuilding purposes, unless the gap is made up by other sources. And we see no evidence today that other sources are making up the gap which inevitably has to take place under existing developments within the savings and loan industry.

Insofar as inflation is concerned, if there is a rapid shift of funds from one sector to another it could cause inflation, and in the present situation, I think this is a real problem.

The CHAIRMAN. The fact that the Federal Reserve took this action on December 6, 1965, to raise these rates really 37½ percent from 4 percent to 5½ percent under the law, the Employment Act of 1946, it is the duty of the Federal Reserve to coordinate these actions with the other agencies effectively.

Were you consulted prior to that announcement of the increase in rates on December 6, 1965?

Mr. HORNE. No, sir; I was not and the Chairman of the Federal Reserve Board as I recall, when he was asked the same question before the Joint Economic Committee, gave the same answer that I have given, that we were not consulted.

The CHAIRMAN. It appears to me that there is something badly wrong in our economy, particularly in our institutions, our financial institutions, when one has so much power, the power of life and death over thrift institutions to just arbitrarily take an action, that although it will considerably benefit the commercial banks for obvious reasons, it will absolutely, it will destroy thrift institutions. Do you not think the action of the Federal Reserve really jeopardizes the security of the savings and loans and other thrift institutions of this country, Mr. Horne?

Mr. HORNE. Mr. Chairman, there is no question but what if the present development continues and grows in intensity, that there is definitely going to be a danger here that I think no one wants.

I would like to say, if I may, sir, in connection with the lack of coordination or consulation, if that is a good word to use, that was true up to the 1965 action. Since that time, a committee has been established in which either the Chairman of the Federal Reserve Board participates, or the Vice Chairman participates. I don't think that what happened in 1965 would happen again. Of course, we would have no control as everyone here knows, over whether or not the Federal Reserve Board raised CD's or did something else. But we do have now a very close working relationship as far as keeping each other advised and informed is concerned.

The CHAIRMAN. That is locking the barn door after the horse is stolen. The damage in December 1965 will be with us a long time as you know and I know that the Federal Reserve is having the Council of Economic Advisers down at the Federal Reserve Board to meet every now and then. But, of course, they are not giving up any of what they call their independence, which I think they just seized. They do not have it as a matter of law. Nobody ever gave

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them independence. You will not find anything in the statute indicating independence. And certainly, they do not have their independence and they are not the fourth branch of the Government that they claim to be. They are just not. But they are going their own way and they defy the President of the United States and other agencies of the Government as well as Congress.

If you will notice, when they have these meetings down at the Federal Reserve Board, they never let you stay there while they have the Open Market Committee meetings. They run you out. There is nobody there as far as the fellows who are interested in high interest rates and they are running the things like they want it and it is in secret, like yesterday. They had a secret meeting yesterday down there. There are 500 people in the United States who know exactly what happened. Nobody else knows. Of course, that gives the 500 of those people a great advantage in operating their businesses in a more profitable way because of that knowledge. That is something that is rather obnoxious to a democratic form of Government—a democracy or republic—that we have and it is going on right here in broad daylight in the United States of America.

Do you not think, Mr. Horne, the practices that have been built up are a violation of the law about paying interest on demand deposits?

Mr. HORNE. I am not quite sure I understand your question.

The CHAIRMAN. You see, when Congress established the FDIC, the banks were going to have to pay insurance fees of about one-half of 1 percent. So the bankers wanted some advantage to compensate for that and it was finally agreed that we would write into the law prohibiting commercial banks from paying interest on demand deposits.

Now, that immediately saved the banks billions of dollars by just paying a small sum into the FDIC fund every year. But it was put in the law and it is there right now. Since they are issuing these negotiable CD's, although they may run for 5 years, possibly, or 1 year, they are immediately cashable because they are equal to interest-bearing currency. They can be sold in the open market. They can get their money back quickly whereas you could not do that on true time deposits.

Has it occurred to you that this would be in violation of at least the spirit, if not the letter of the law to pay interest on demand deposits?

Mr. HORNE. I should think after your explanation of it, it is something that could very well be questioned. It may be a very technical difference in interpretation here and I am not a lawyer and I don't feel qualified to answer your questions specifically that it is a violation.

But, from your citation of the law, it would indicate to me that this is a practice that if it is continued this committee has every right to look into it thoroughly and take corrective action that it deems advisable.

The CHAIRMAN. If the Federal Reserve has ever attempted to enforce that act against anybody, I do not know about it. In this case it is so open and flagrant that they should be certainly called upon to explain it and why they did it and I think we shall do that.

The Joint Economic Committee hearings on December 13 and 14, those hearings are available and anyone who is interested may have them. I assume you have seen them.

Mr. HORNE. Yes, sir.

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The CHAIRMAN. I think they are very interesting and bring out some very important points.

For instance, when Mr. Martin said that he did not raise the savings rate, I believe it was 4 percent, if you will notice I asked him some questions there, what would keep people from taking the savings out and put it in CD's and he never could explain. I assume you noticed that.

Mr. HORNE. Yes, sir. This, Mr. Chairman—this is one point that we have raised and in my testimony made clear, I think. We still raise that question.

The CHAIRMAN. Yes, sir. Now, the new tax withholding law requires holders of large corporate funds to make a report about every 2 weeks, does it not?

Mr. HORNE. I am not sure.

The CHAIRMAN. They make payments into the Treasury.

Mr. HORNE. Yes, sir.

The CHAIRMAN. Would that affect in any way these certificates of deposit accounts that they carry or would they not have less money?

Mr. HORNE. Well, if I understand the question correctly, Mr. Chairman, I should think they would have less money.

The CHAIRMAN. Like the large corporate funds. You know that when the corporations turn to CD's, that affected seriously and quickly the short-term Government securities market.

Mr. HORNE. Yes, sir.

The CHAIRMAN. For the obvious reasons. The corporations had been using these huge funds to bid on the short-term security offerings every Monday and that kept it down. By reducing them to leave that short-term auction every Monday and going to CD's, they immediately got a big windfall or bonus by increased interest, but it caused a race between short-term security rates and the CD rate. This is a race which could cause inflation. In fact, we are paying today for the same amount of money, $30 in interest charges for every $1 interest we paid during World War II. That is the most inflationary thing of all times.

Mr. Reuss?

Mr. HORNE. Mr. Chairman, would you and the committee object if Dr. Schwartz made a comment?

The CHAIRMAN. Be glad to have Dr. Schwartz' comments.

Dr. SCHWARTZ. All I was going to say, Mr. Chairman, is that I recognize the merits of the position you are taking, but we have a little bit of difficulty supporting it statistically. If you look at the short-term interest rates at the end of 1959 when they were at their peak at that time, they were slightly lower than short-term interest rates are now. I am talking about 3-month paper—3-month bills.

If you look at the 6-month bills and the 9-month issues, they were a little higher than they are now. So the figures don't help us very much to determine whether these CD's are really causing the kind of pressure on the money market that I think your remarks suggested and which may indeed have occurred. Interest rates may have been lower without these negotiable CD's. But we can't demonstrate this statistically.

The CHAIRMAN. May I comment just briefly on that.

I do not think anyone can dispute that when you take $16 billion or $17 billion out of the market, the auction market that is depending

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on short-term securities all the time, take that away entirely and put it in something else like CD's and in a few banks, that would not seriously affect on the upward side interest rates on short-term Government market?

Dr. SCHWARTZ. Well, I think there is a lot of merit to what you say as I indicated before. Running CD funds through another circuit can cause market frictions which put pressure on interest rates. But the argument that is made against it to us when we raise the same question is, well, that money is lent out to people who would otherwise have to go to the market and compete against securities by issuing their own paper. So we end up in the argument going around a circle and in order to try to support the point we made we went to the data and the data didn't help us very much. That is all I am trying to say.

The CHAIRMAN. I do not care what they say, the facts are evident and undisputed and can be documented and that it did seriously affect interest rates.

Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

On page 1 of your statement, Mr. Horne, you say:

> Since 1961, the increase in negotiable certificates of deposit has been quite large.

Now, Webster defines "quite" in two ways—one is "rather large" and the other is "extremely large." In fact, since 1961 negotiable CD's have gone up in volume from practically nothing to some $17.5 billion; is that not a fact?

Mr. HORNE. Yes, sir.

Mr. REUSS. Therefore, you meant extremely large?

Mr. HORNE. Extremely could very appropriately be substituted for the word "quite."

Mr. REUSS. I wanted to have you tell me which of the two meanings you meant.

What this whole thing boils down to, it seems to me from your very excellent testimony, is that a large part of the Nation's savings which, had they remained in the savings and loan associations would have gone to build homes and are instead going to banks and as you said, on page 4 of your testimony, because of the nature of bank lending, it may mean that they go into inventory loans for business and in some cases into plant expansion.

Mr. HORNE. Yes, sir.

Mr. REUSS. Now, this committee is very concerned with inflation. What do you say about the ability of the economy to respond to a demand for more homebuilding in contrast to the wisdom of the economy's building up inventories, let us say?

Mr. HORNE. Well, sir——

Mr. REUSS. I want you to put on the hat of say the President or the Chairman of the Council of Economic Advisers rather than just your Home Loan Bank Board hat.

Mr. HORNE. Well, I want to give a responsive answer to your question.

In some parts of the country there is presently a surplus of homes. And unquestionably there is a slack of homebuilding to some degree. It is not necessarily harmful. We are concerned, though, about the most recent figures which I pointed out in my testimony, that from

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here on out for the remainder of the year, we may have a very sharp—too sharp in our opinion—drop in the availability of money for homes.

Now, if there is a shortage of money, then this within itself could contribute to the inflationary process. With the relatively small amount that will be available for lending purposes, it is just natural that the lender, whoever he may be, is going to charge a higher price to the borrower of the money with which to buy a home. And this can also be argued as contributing to inflation. I am not an economist and I am not a lawyer, but I guess part of inflation is a total cost of everything that the consumer has to have and if the consumer is buying the home and he is paying more for the money he is borrowing, this is adding to the cost of living and this is in a way inflation as far as he is concerned.

Mr. REUSS. I was looking at it in simpler terms, perhaps. If, in considerable sections of America today there are building tradesmen available to build homes, and building materials available as material, which are not now being used because of lack of mortgage money and the high price of mortgage money, and if at the same time businessmen are building up inventories in excess of that necessary for the reasonable flow of the economic process, then the Government, or the Banking and Currency Committee which has overall jurisdiction, is being improvident.

Now, is that the situation? If, for example, inventories in business were at too low a level and if there were no more capacity to build homes than are now being built, then I would say about the only objection one could make to the Fed's CD action was to say that it is somewhat socially inequitable to the homeowner. But, if, as I suspect is the case, and I hope you will tell me, there is a capacity in this country to build more homes than are now being built at the current short rate of mortgage money, and if business inventories are at an adequate level, then the Fed is really entering this inflationary area and this committee should come in and stop it.

Mr. HORNE. Well, I am not—I don't have the information as to inventories with me, but I think your analysis, Congressman, is entirely correct and we do know that there is more capacity to build homes than is presently being used. I am not so concerned about this at the immediate time, but I am concerned as we go later down the months of this year, because there can be a much greater oversupply of capacity than we presently have and there can be an undersupply of homes, even though as I have indicated in some areas, we could very well afford a slackening in homebuilding. This is a spotty situation. And so, it is true that if we are drawing money from one source, that is a very important part of our economy, we are affecting that particular source. If we aren't compensating for it someplace else, this is important. I have my doubts that without inflation if the funds can be absorbed elsewhere right now. We can, therefore, be creating difficulty in the economy as a whole.

Mr. REUSS. You see, we of the Banking and Currency Committee in a sense, and nobody else seems to be doing it, have to act as umpires here. We have to try to determine where the Nation's savings can best be channeled and accordingly, file for us an analysis by you, of present and potential capacity in the homebuilding industry, both what it is now and what it will be later on this year and in the months

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to come, and also your judgment and that of your economists, and I know you have them, on whether the Nation's inventory situation is such that businessmen desperately need the bank lending power which has been purloined from your institutions to the banks by the raising of CD interest rates.

Is that not an answer to a question that we need to know?

Mr. HORNE. Yes, sir; I think it is.

As far as the inventory situation is concerned, outside the home-building area you probably can get more expert information from the bank agencies themselves. However, if you should like for us to prepare a résumé of our own opinion, to submit to this committee, I would be very glad to do so.

Mr. REUSS. I would like it because the banking agencies tend to be special pleaders for their clients and obviously the Federal Reserve, although we cannot gather this from their very cryptic statements, must have thought that further inventory loans were in the national interest or they would not have put banks in the possession of the power to make these loans.

Mr. HORNE. It is a tremendous problem with which the committee is struggling. I am sure, too, that people who are not on the committee are also struggling with the problem. What to do about the fact that there is a shortage of money is a crucial issue. What kind of process can be used, if any, to say who gets this money and then for what the money is loaned once the institution has it is another question. And also, under what terms and conditions the institutions—banks, savings banks, and credit unions are tied in—are going to lend. How we handle this problem of allocating or using and determining where the money that is available is going to be spent is not easy.

(The information referred to follows:)

STATEMENT ON SHIFTS IN DEMAND AND INFLATION

The following statement is made pursuant to the request of Congressman Reuss for comments on the effect of shifts in savings and credit flows which shift demand from construction to other industries. Congressman Reuss asked whether this could have an inflationary effect. Our answer is yes, and explanation follows.

The housing industry is undoubtedly operating below capacity at the present time. During the current period of economic expansion, nonfarm private housing starts have come close to an annual rate of 1.8 million units at the peak. In contrast to this, housing starts are now down to 1.5 million units. Unemployment in the construction industry in March 1966 was 9.9 percent, the highest of any of the major industry groups. It should be noted, however, that unemployment in this category has been high for some years.

Nevertheless, on the basis of these facts, we believe that the capacity of the housing industry is at least 1.8 million units. This is not to say that such a rate of housing activity would be desirable at the present time in terms of underlying demand. In the past few years, even at a level below 1.8 million units, housing production has resulted in the emergence of surpluses and a subsequent reduction of housing production. The recent level of 1.5 million units is probably somewhat above a sustainable level of production, although the reduction of credit into the housing sector could well reduce housing starts significantly below this and far below what is sustainable.

Any estimate of the capacity of the housing industry must obviously be dependent upon many factors. Housing does use some materials and labor utilized by other sectors of the economy. Recent increases in demands upon these have probably reduced the ability of the housing industry to expand much without resulting in some degree of price increases. However, the capacity to produce is above recent levels and well above prospective levels.

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On the other hand a shift in demand toward inventories or plant and equipment expenditures has contributed and is likely to continue to contribute to inflationary pressures. The reason for this lies in the very large increases in demand that have occurred in the nonhousing industries and the resulting production close to or at capacity. Thus:

1. Plant and equipment spending is expected to rise 16 percent this year.
2. The buildup in inventories by businesses continues to be rather substantial. During the first quarter there was an $8.3 billion expansion in inventories, close to the very substantial rate in 1965 and well above the rate of other recent years.
3. Manufacturers' new orders continue to reach new peaks and are in excess of shipments. The result has been an almost continuous rise in backlogs of unfilled orders. These backlogs in the durable goods industries reached $66.2 billion in March, up from $55.5 billion just a year before.
4. Overall unemployment is down to 3.7 percent as compared to a level of 4 percent normally associated with full employment and price stability.
5. Capacity utilization has risen significantly since last fall, according to data gathered by McGraw-Hill, and a number of industries are operating at levels above their preferred rates.

It should be noted that not all of the resources in the construction industries are readily transferable to other sectors. Witness the high rate of unemployment in the construction industries. Thus a demand shift from construction to other industries is not fully offset by a shift in resources. The speed of increasing demand in other industries is an inflationary factor.

Mr. REUSS. One final question. Before Chairman Martin and his Board adopted their CD action early in December of 1965, did he confer or consult with you about the effects of such action on our homebuilding industry and on the Home Loan Bank Board?

Mr. HORNE. You say, did they consult with us? No, sir; they did not. As I explained to the chairman a few moments ago, they have been meeting with us and the Comptroller and the FDIC since then very regularly, but they did not prior to taking the action of December 6, 1965.

Mr. REUSS. Thank you.

The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

Mr. Horne, we certainly welcome you before the committee and we know your testimony will be very valuable.

Mr. HORNE. Thank you.

Mr. WIDNALL. As you know, I made a suggestion that the Chairman of the Federal Home Loan Bank Board be added as a member to the quadriad. I wrote to the White House in that respect and asked for serious consideration of that proposal. I have not yet received any response from the White House on that and I wondered whether or not you were aware of any response or reaction by the White House to that suggestion?

Mr. HORNE. No, sir; I am not, except, I believe that the Secretary of the Treasury before one of the committees was asked the question—I don't remember on which occasion, but this is the only response of which I am aware.

Mr. WIDNALL. I still think that with the importance of the savings and loan industry and the tremendous amount of influence in the development of homes in America, that it is extremely important that a full voice be heard at the present time.

Mr. HORNE. Of course, that could be done—that could be one device for this to be done. It could be done other ways. I do want to say, and I believe in the long run it will be helpful, that there is more consultation, more exchange of information now.

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Mr. WIDNALL. Than there has been?

Mr. HORNE. Yes, sir; by far. I think, too, sir, unquestionably, you are right when you imply that the savings and loan industry is now so large in the amount of savings involved, and the impact that it can have in the economy of the country, that it no longer can be considered a relatively insignificant influence as was the case perhaps 15 or 20 years ago. It is now very large and it is appropriate that action that would affect it be discussed with the Federal Home Loan Bank Board before such action is taken.

Mr. WIDNALL. On page 5 of your testimony you say:

> A minimum size limit for all these instruments and the appropriateness of multiple maturities and automatic renewal should also receive the committee's attention.

Do you have in mind any minimum size amount?

Mr. HORNE. I think here, Congressman, that you might want to indicate, if the legislation should be passed, giving the appropriate agencies the authority to do this, that either in the legislation or in your report, you might want to indicate some guidelines. I don't have anything to suggest except that—off the top of my head, I would suggest $25,000.

Mr. WIDNALL. $25,000 as a minimum?

Mr. HORNE. Yes, sir; as my testimony, I think indicated, there is evidence in here that the smaller the CD's the more likely is the shift from thrift institutions.

Mr. WIDNALL. Mr. Horne, the House will probably vote tomorrow on the Participation Sales Act. In that we are talking about the sale of $8 billion of participation certificates in 2 years. This is with the very likelihood that the annual rate of sales could reach $5 to $6 billion per year within a few years. If the Congress or FNMA saw fit to sell these certificates in denominations as low as $100, what impact might that have on savings and loans in view of the fact that yield to investors is likely to be in the 5½-percent range?

Mr. HORNE. Well, frankly, Congressman, I haven't analyzed this particular situation. I am sure that the people who recommended it have good reason for doing so. It is part of the administration's program, as the committee knows. I think in all frankness, I should say that I have not made an effort to study what impacts it might have on thrift institutions, but I am not aware of a $100 participation unit.

Mr. WIDNALL. I have a very strong feeling that if this program goes through, that it is going to further damage the mortgage market, the general mortgage market and make it a great deal more difficult for the true mortgage bankers and the savings and loan institutions to perform their function, their true function with respect to lending to the building industry and make their great contribution in the way they have in the past, in the next few years.

It seems to me, too, that this is being used as a device to get around the 4¼-percent ceiling on Government bonds to bring everything up to 5½ percent. The impact in many segments of our economy can be great and I do not think it can be sloughed off as just putting it in the hand of private investors—assets that are held at the present time. I think that is a fiction, too, because all we are doing is transferring it into a trust and selling participation in it and the Government is still holding the assets. I do believe that it is incumbent upon you as head

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of the Home Loan Bank Board and others in doing so well in trying to guide the savings and loan institutions, that you be fully aware of what it might do to the mortgage market in the future by providing an entirely new means of financing with a great deal of appeal, because of a guarantee, and it can go higher. There is absolutely no guarantee that it would not go higher.

Mr. HORNE. I must confess I have not made a study in depth of it. I realize one thing, the administration—the administration is making it possible for the private sector of the economy to take over these loans that are presently held by the Government. Now, if managed properly, the possible adverse effects on other entities could be at least considerably reduced or prevented. I think it would depend to some degree, and I am just talking in answer to your question, that if it is managed carefully and handled properly, much of the possible danger, if not all of it, might be alleviated.

Mr. WIDNALL. That is all. Thank you.

The CHAIRMAN. Mr. Stephens.

Mr. STEPHENS. Mr. Horne, I am glad to have you again before our committee. It is a pleasure to have you here.

Mr. HORNE. Thank you, sir.

Mr. STEPHENS. I want to know if I gather correctly the impression from you that so far as the negotiable certificates of deposit are concerned, that you are not quite so concerned as far as savings and loans are concerned about whether they are negotiable or not negotiable, but what you are primarily concerned about is the smaller denominations that people get at the $10,000 insured level down to $25.

Mr. HORNE. Yes, sir; that is right.

Mr. STEPHENS. As far as your testimony is concerned, that is where your chief concern is as far as your particular field is concerned?

Mr. HORNE. Yes, sir; that is correct.

Mr. STEPHENS. I would like to ask one or two questions in respect to some statements that you have made in answer to some questions.

I am very much interested as you are and all others as far as inflation is concerned. We would like not to have inflation. What concerns me is the other side of the coin, and that is, a depression. We do not want that, either. Recently, the Regional Home Loan Bank Board sent to each savings and loan a letter from you saying that after the next interest is payable after the first of July, that when a savings and loan institution comes to the Board for the purpose of borrowing—which it is entitled to do and one of the greatest assets of the system—that the Board will look very carefully at what commitments they have made and as I read it, it is going to be a little bit difficult for them to borrow money—for the institutions to borrow money—if it does not have any in the institution itself. It will have more of a difficult time borrowing the money through the savings and loan facilities.

Now, that will have an effect in my section where we have a shortage of homes of cutting out a lot of building and it would not be a question of inflation as far as the building industry is concerned. But it may cause a real depression in the building sector. You are going to find no housing starts and when that happens you have got all kinds of things. People who work in those trades, like carpenters, brickmasons, and plasterers and people who have small construction organizations and cannot hold them together, while hoping things will be alleviated,

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are going to be in a depression in that kind of situation if you cannot start any homes in any reasonable amount of starts.

The shortage of homes and money will make people go to other financial institutions or other places to get money where it costs them more money and all that sort of thing will not add up to inflation, it seems to me. It seems to me it is going to add up to depression because in my personal opinion, if I do not have any income and I cannot get any credit, then I cannot spend anything. Under that circumstance, it is just plain depression and that is why I am afraid of that more than the other because we might go too far.

Would you like to comment on that?

Mr. HORNE. I should be glad to. Unquestionably, if there is a drastic drop in any large and influential part or sector of our total economy, it can have an anti-inflationary effect, but it can lead to deflation, particularly in that area, if not overall.

Now, no one knows at this particular time just how great the drop in homebuilding is going to be so far as total availability of funds from the savings and loan industry is concerned. It seems now to be shaping up to a decrease of some 20 to 25 percent from what it was last year, 1965.

As I said a few moments ago, there are some parts of the country where this is not necessarily bad. As a matter of fact, there are some spotty areas where they might be good. But if the slack that is being experienced insofar as financing by the savings and loan industry is concerned is not absorbed by other sources, and presently we see no evidence that it is going to be absorbed by other sources, then you can have a situation in which there is too little investment or too little money available for the homebuilding part of the economy.

Now, the purpose of our April 20 letter to which you referred, is to make certain that what is available would go to homes. As you know, Congress from time to time has given to the savings and loan industry an additional lending authority, and we want to make certain that as far as the money they borrow from each of our 12 banks is concerned, but this is one thing we have in mind, that we know somewhat for the purpose it is being borrowed. We also want to make certain that they use their own funds as wisely as possible without relying on funds from the 12 banks except in areas that are needy areas. We make loans for expansion purposes under certain conditions, but we are primarily concerned about meeting liquidity requirements, meeting seasonal advantages and seasonal needs and things of this sort. These generally are what we had in mind in this April 20 letter.

Mr. STEPHENS. I appreciate that explanation. Of course, I agree with what you just said, that if there is going to be anything that is going to have to be curtailed, then the savings and loans should emphasize what I think is the primary purpose and for what it was created and that is homebuilding.

Mr. HORNE. I do think Congress in the past has acted wisely in granting some additional authority to the savings and loan industry. The Federal Home Loan Bank Board is on record that there are certain other areas which we think also would be appropriate places in which to grant lending authority, so that in times when there may be an excess of money for strictly homebuilding purposes, they might

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very well diversify their portfolio, and incidentally might be better able to stand strains and stresses that come in the life of any financial institution.

Mr. STEPHENS. Thank you. My time is up.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. We are glad to have you with us. It occurs to me, I do not think there is any cause that is attributable to your action. The SBA's run out of money.

Mr. HORNE. I guess I am a bad omen.

Mr. ST GERMAIN. The experience that we have in the northeast area, the wells are just drying up in the savings and loan people and the savings bank people as far as available funds to lend out to homebuilders are concerned. You suggested some changes, Mr. Chairman, that may be made as far as the Board is concerned and the Congress might cooperate in. However, do you not feel that the true solution here is the certificates of deposit and the drain that they are causing on the available and ready money?

Mr. HORNE. You are talking about certificates of deposit within banks now. You are not talking about S. & L. certificates. Well, certainly, as evidenced in my testimony, this is one area in which the small CD's are quite evidently, when they begin to pay 5, 5¼ percent, drawing money from thrift institutions. I think, though, and I am sure the Federal Reserve Board would do this much better than I am prepared to do it, I think we have to keep in mind, though, that this is not the only source that is competing for funds and this is not the only source that is causing less inflow of funds into the thrift institutions than was the case a year or 2 years ago.

It might also be of interest to the committee to have these figures, because they are in some degree a response to your question about money drying up in the Northeast.

In 1965 the repayments into the savings and loan industry from people who had borrowed money for building and other purposes amounted to about $15,300 million. We estimate the repayments for 1966 will be about $14 billion. Net savings in 1965, and this included dividends credited to savings, amounted to $8.2 billion. The estimate for 1966 is about $4.4 billion.

This means that from these two sources the savings and loan industry at the present outlook will have available about $5 billion less than it had in 1965. This gets back to another figure that I used in my testimony, that seemingly, the savings and loan industry is going to have for lending purposes between 20 and 25 percent less than they had in 1965. This is not only evident in the Northeast, but also in other parts of the country, there is going to be less money available from the savings and loan industry than there was available in 1965.

Now, this is also related to Congressman Stephens' question as to how they make up this deficit. They can't hope to make up this deficit by coming to the windows of the 12 district banks to borrow. They will be able to come to the banks and get what is needed so far as their own liquidity is concerned, but there will be a shortage of funds even at the bank so far as expansion is concerned.

Mr. ST GERMAIN. So, to capsulize, Mr. Chairman, the time has come for very definite and effective steps to be taken in an attempt to alleviate the situation if we intend to see to it that people who need the

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funds to buy homes and build homes can find these funds at a reasonable rate of interest?

Mr. HORNE. If some mechanism can be found whereby you can control to what savings institutions people's savings go and then you could determine where this money is loaned once it gets into these institutions, I would say you were at the crux of the difficulty. Otherwise, with the free market and also with the many other things, as I indicated a few moments ago, that people are doing with their money, other than just CD's, it is a very difficult situation right now to determine exactly the manner in which to best handle it.

Mr. ST GERMAIN. Thank you for your thoughts on the subject.

The CHAIRMAN. Mr. Fino?

Mr. FINO. Thank you, Mr. Chairman.

Mr. Horne, do I understand from your testimony here this morning that it is your feeling that if money continues to flow out of the savings and thrift accounts into commercial banks that this would affect the mortgage market?

Mr. HORNE. It is bound to affect the amount of money, Congressman, that is available for investment in the mortgage market unless as I say, this cutback, this necessary cutback on the part of S. & L.'s is made up elsewhere and I don't think it is going to be made up elsewhere.

Now, we cannot tell at this particular time how severe this cutback across the board in the market, in the mortgage market will be. As I have said, there are some areas where a cutback will be healthy. But if the cutback is too great across the Nation as a whole, then people are simply going to be able to buy fewer homes than they've bought in the past. This may not in itself create for the economy a wholly unusual, severe situation that can't be weathered. I think the whole thing depends on how steep the cutback is. Certainly if the cutback is extremely deep then the people who are engaged today in the homebuilding process, whether actually putting the bricks and lumber together or whether they are manufacturing items to go into the making of the home, it will necessarily cause cutbacks in their activities which may or may not be absorbed in other parts of the economy.

But all of these things are interrelated as you know. One is not separated from the other.

Mr. FINO. We have two giant banks in New York: First National City Bank and the Manufacturer's Hanover, and I assume that they are issuing CD's. These two big banks are competing with each other and certainly against all of the savings and loan banks for mortgage money and they are giving the best interest rate and are attracting mortgage money in New York City.

Now, I think the fear is not so much the loss of money from the mortgage money market than the loss of money to these banks through the issuance of CD's.

You testified recently before the Senate on some legislation affecting savings and loans. Mr. Horne, could you tell us, are the savings banks, the savings and loan associations throughout this country in serious trouble?

Mr. HORNE. To give you the correct answer and the appropriate answer, if you take the picture as a whole, the answer is "No." I wouldn't want to——

Mr. FINO. I asked the question seriously.

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Mr. HORNE. No, sir; as a whole there are a few that are. But the thrust of my testimony before the Senate committee and which I hope eventually to present to this committee has to do with 2 or 3 percent of the problem cases in which there is either incompetent management or in some cases dishonest management. This is a very, very small part of this industry. Unfortunately, when this is talked about, sometimes the news stories don't stress that 97 or 98 percent of our managers are well-intentioned, good, honest people. They stress sometimes more the 2 or 3 percent. I think it is very urgent and very important that we get this legislation to get at this 2 or 3 percent because they are unnecessarily impairing the public image of the 97 or 98 percent that are good. But this is another problem.

As far as liquidity goes I think we can weather this particular storm. But I think it has to be watched. I think presently money is flowing out of S. & L.'s into banks because of CD's in some cases. As I indicated, this is not the only competition for funds so far as the S. & L.'s are concerned.

There are other things that are competing for funds, too, which are having an effect on the amount of money that flows into S. & L.'s. We may have to advance money from the 12 Federal home loan banks to the savings and loan industry to enable them to meet that liquidity problem. We may have to cut down the funds available for them to use for lending purposes. But as I also indicated, we have money flowing into the savings and loans through repayments which is going to be a great deal of help.

A problem we have in the savings and loan industry is, that the moneys are invested in long-term mortgages, they can't turn the money over the way banks turn the money over. They don't have the flexibility as the English system has, that when things get tight the interest that they charge on loans outstanding is immediately raised accordingly. We don't have that in this country. The Federal associations have the right to put it in the contract when they loan money, but it is not exercised because of competition that is so keen from other sources. Getting back to trying to answer candidly your basic question, "Is the savings and loan industry as a whole in trouble?" I would say not in any trouble that we can't meet. Not in any trouble that would cause panic. But the situation is pressing enough that we must explore things that this committee is exploring and the Board itself must explore ways and means not only within the Board, but with other Government agencies as to how we can meet any problem that might come down the road in the weeks and months ahead.

Mr. FINO. Is there any prohibition on any of these savings and loans and thrift accounts from issuing CD's?

Mr. HORNE. From issuing CD's?

Mr. FINO. In competition with the commercial banks? There are charges that the commercial banks are taking all the money away from them with the CD's which have higher rates of interest. Cannot the savings banks and savings and loan associations issue CD's and keep the money?

Mr. HORNE. I am not as familiar with the savings banks as I am with the savings and loans because they do not come under our supervision and jurisdiction. As you know, they are State entities and the State laws apply to them rather than Federal laws.

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The answer to your question, "Can they not do the same thing?" This is somewhat a yes-and-no answer. The one thing we have to keep in mind, and it is a fact that I made reference to a while ago in my statement, that money is tied up in long-term mortgages. The interest rates they can charge are fixed by contracts. This means that they are restrained in how much they can earn. And if they are restrained on how much they are earning they are also restrained on how much they can pay their savers. The situation is, that if the savings and loan industry took on the commercial banks in a rate war, because of the condition of their portfolio as I have explained, they simply would be the loser. And so both on their part and on our part at the Board, we have tried to practice restraint in this area. We have given them flexibility. We now have under study the granting of even more flexibility which I think we will announce either this week or the early part of next week.

We have to bear in mind what they actually can afford. This might interest you to some degree—during the past 3 or 4 weeks I have, by going to what we call stockholder's meetings in the banks, I have asked the savings and loan managers, several hundred in each case, to raise his hand who would like to have a 5-percent certificate. In one bank district five people raised their hands and in another bank district six raised their hands. In another one three or four raised their hands, and in the State of New Jersey just last week, not a single person raised his hand.

One thing that they recognize is what I just said, there is a limit on how much they can earn. And consequently how much they can pay for savings. Also, they know whatever they might go to today, that banks at the 5½-percent present authority can outbid them and they simply cannot meet it. They want to get by if they can, and I think we should, without engaging in a rate war.

Mr. Annunzio. Will the gentleman from New York yield?

Mr. Fino. My time has expired.

The Chairman. Mr. Gonzalez.

Mr. Gonzalez. Mr. Horne, our colleague from New York has raised an interesting point here. I am just wondering, though, he suggested New York banks are finding it possible to invest their money in mortgages at a higher rate, say 5½ percent. If so, this is the most unusual situation. I did not think this was prevalent in the rest of the country. Is this the case?

Mr. Horne. Our evidence is, Congressman, and I think we have some figures on it for the committee—I don't know if we have it at our fingertips. Our evidence is that this is not the case in the country, nationally speaking. The banks did in 1964 and 1965; I think I am right about 1964. They did go into the mortgage market more than they had done previously and held that rate in 1965. But evidence that we have now shows that they are dropping out of the mortgage market as compared to last year. This is true in New York as well. I can't answer on an individual-bank basis.

Mr. Gonzalez. It seems to me, what has really happened in our country is that we are federalizing the loan sharks.

Mr. Horne. Doing what, sir?

Mr. Gonzalez. We are federalizing the loan shark. On the State level we have this like a cancer. Back in Texas, as we say, our State

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is the "Loan Shark State"—loan shark capital of the Nation and it has been very interesting to watch some of the gyrations, for instance in the last session of the legislature, both the banks as well as the savings and loan institutions pushed for approval of a law that would legalize 17½-percent interest on loans up to about $1,500 or better. Fortunately for us, the Governor vetoed that bill. Of course, a lot of us had to do a lot of pleading, asking him to do that. The reason is also quite obvious—the reason is quite obvious and that is, since the adoption of the regulatory law in Texas, a lot of loans that the banks were losing were going to the finance companies other than banks and other established institutions. We have the U.S. Comptroller of the Currency announcing that it is his interpretation of the law that the national banks are empowered to charge the highest rates of interest permissible under State regulatory heads. That would mean in Texas that the national bank could charge on certain types of loans up to 300 percent per annum which in certain cases is legalized in Texas.

It seems to me—coming out from the boondocks in Texas, as I have, serving on the State legislative level in the senate, and then coming up here to Washington—that I readily identify the animal by his tracks. I think we have been taken over by the loan sharks whether it is in CD's—not to be confused with the DT's.

I just wonder if there is anything you can see from the standpoint of congressional action that could be done to forestall this apparently—to stop these unconscionable interest charges?

Mr. HORNE. Well, that is such a big task, I really don't feel adequately competent to elaborate on it. I don't know that I have the information to elaborate on it. We are torn here on the one hand between a shortage of money and naturally when there is a shortage there is going to be higher charges for it.

Personally, my sympathy is on your side. I wish there were some way that the person who has to borrow money, but particularly the person who desperately needs it and can't get along without it wouldn't have to pay exorbitant rates for it. But there is such a difference of opinion here. Some people, as everyone here knows, argue that you have to charge higher rates to cut down on the amount—people who have the willingness to borrow and consequently through their process controlling inflation.

There is another argument on the other side that is just as strong. So I say personally I am in sympathy with the lower charges. But just how Congress or anybody can get at that particular situation that we are talking about now, I frankly don't qualify to give all the answers to it. I do think that what I have suggested about the CD approach is one—is one way that would provide some help. But I do want to emphasize that it would have to be done—both facets I mentioned are a gap.

I am also aware of the fact that the savings passbook rate could be raised and I commend the Federal Reserve Board for its restraint in this area. An increase in the savings passbook rate would in itself have an effect not only on the cost of the money people would borrow, but certainly would have perhaps an even more direct effect. It could have more effect on the flow of money into thrift institutions than the use of CD's. So the whole problem is really a very, very difficult one.

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Mr. GONZALEZ. It just seems to me, and I could be wrong, but it just seems to me that one thing feeds on the other. I have seen this process, as I say, on a more localized basis and I have seen things happen here on the national level. I would hate to see the Texas technique nationalized.

Mr. HORNE. I certainly would agree with the Congressman on that point.

Mr. GONZALEZ. My time has expired.

The CHAIRMAN. Mr. Minish.

Mr. MINISH. Thank you, Mr. Chairman. I want to commend Mr. Horne on a very fine statement.

Who is affected by the abrupt outflow of funds from the thrift institutions?

Mr. HORNE. Who would be affected?

Mr. MINISH. Who is affected by the outflow of funds from the thrift institutions?

Mr. HORNE. I guess the person who would be most immediately affected would be the home borrower, the person who wants to buy a home, and if the construction level falls to the extent that it isn't available, which is likely, he would be affected and then the fellow who wants to borrow money on homes that are available is also going to be affected, because as you have to pay more to get money in savings, you are going to have to—you are going to have to charge more for it. Plus, the added fact, just the natural law of life in this country, if there is a shortage of money you are going to charge a little bit more than what you have available to lend than otherwise would be the case.

The CHAIRMAN. Mr. Halpern.

Mr. HALPERN. Yes, Mr. Chairman.

Mr. Horne, you talked about money being taken out of savings and loan associations. Now, under the proposed Sales Participation Act, banks will be buying these certificates at 5½ percent. As it is now, this is clean money, although all they have to do is cut coupons. Is not this money being withdrawn from the mortgage market?

Mr. HORNE. I suppose my response here, Congressman, has to be perhaps twofold.

One is, I have not made a careful study myself and the Board has not made a careful study but does not believe there would be adverse effect on thrift institutions as regards this program.

Another point is that it is primarily, at least to a great degree, a question of how it is managed. I should think that those who are in charge of managing this program, if it should be approved and if they do operate under it, are knowledgeable people and that they would keep in mind, if it is managed improperly, it could cause some difficulty.

Frankly, I have confidence in the people who would manage it, and I think they would try to handle it in a way that would not cause adverse effects on other parts of the economy. I would hope and expect they would do a similar thing to what we do at the Board, for example. On occasions when we take over the assets of a disappearing savings and loan association to liquidate those assets, we keep in mind what the market conditions are in that area and not unload in a manner that would impose a handicap on the savings and loan

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associations or even on other people who deal in the mortgage market situation. The record shows that the participation program has been tailored to security buyers and not to savings account holders.

Mr. FINO. Will the gentleman yield?

Mr. HALPERN. Yes; I yield.

Mr. FINO. Mr. Horne, you are the representative of a fiscal agency of Government.

Mr. HORNE. Yes, sir.

Mr. FINO. Does not the Budget Dirctor and the Treasury Department call in all of the agencies concerned with the one problem and discuss it before they come out with a bill such as the Sales Participation Act? This bill could very well affect your part of the problem and yet you say you know nothing about it, you have not studied it.

Mr. HORNE. Let me say that I have not studied it in close detail. I am generally familiar with it and while in this case there was not a meeting held——

Mr. FINO. You were not consulted?

Mr. HORNE. We were consulted through the process of the Bureau of the Budget, to inquire of appropriate agencies. To this extent we were consulted.

Mr. FINO. You were consulted by the Treasury Department and the Budget Director. What was the position of the Home Loan Bank Board?

Mr. HORNE. We raised no objection to the legislation.

Mr. FINO. You do not see any fear of money being taken out of the mortgage market by these participation certificates?

Mr. HORNE. I wouldn't want to go so far as to say that this program, if not administered properly, could not take money that might not otherwise go to savings institutions, whether they be banks, S. & L.'s, or thrift institutions. I am saying that this is one of the several factors and one of the several programs that in my opinion has some merit and it would depend on how this is managed as to whether or not it would have that effect.

Mr. FINO. You express deep concern about the CD's—money flowing from one bank to another and yet express no concern about $4.7 billion being taken out of the consumer credit market?

Mr. HORNE. I don't think, Congressman, that that necessarily is so, that all of this $4.7 billion is the kind of money that would flow into thrift institutions in the first place. It is usually money that would go into the security market.

Mr. FINO. It is in the thrift institutions already.

Mr. GETTYS. Since time is getting short, I ask for regular order.

Mr. HALPERN. I have the time, Mr. Chairman.

(Chairman Patman left the hearing room and Mr. Ashley assumed the chair.)

Mr. ASHLEY. As a matter of actual fact, your 5 minutes are about up in any event.

Mr. HALPERN. Thank you.

Mr. ASHLEY. Mr. Hanna?

Mr. HANNA. Thank you, Mr. Chairman.

I want to commend the gentleman, particularly for the high quality of restraint that I read into this testimony that is given at a time of crisis and therefore it does deserve credit.

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It reminds me of the story told about the proper and purely innocent Englishman who got caught in a demonstration that was started by the students in the streets of Djakarta. The police had been forewarned about the demonstration and so were ready with a very large water hose. When they saw the students coming they let loose with the water hose. The Englishman was unhappily placed in front of the demonstration and caught the full brunt of it right in the brisket. He got up with the most composure that he could summon and made the following complaint to the man who was in charge of the hose. He said, "Old boy, can't you swing that thing about a bit? I seem to be getting the brunt of it."

It seems to me that the situation that we see here, Mr. Horne, is that we do have a crisis in liquidity and that the objection that you seem to be raising here is the fact that the brunt of the effect of the crisis of liquidity demonstrably appears to be hitting in the mortgage market and it is being affected adversely by the flow of funds to a degree that is unjustifiable. Is that not correct?

Mr. HORNE. We are concerned about the point, sir, you have expressed. I would want to emphasize, though, that while we are concerned about it, we think that there is going to be no real problem in meeting it.

Mr. HANNA. I hope you are correct about that. If I understand the liquidity need of savings and loans, they fall into five fields: First, the savings and loans hope to have liquidity to make new loans. Second, it certainly needs liquidity to repay any advances made by the Home Loan Bank Board. Third, it needs money to meet the withdrawals in the situation in which withdrawals are occurring and they are occurring at the present time, are they not, Mr. Horne?

Mr. HORNE. Yes, sir; but on that point, I think it might be helpful to the committee to point out that as far as the total inflow is concerned, and the total outflow is concerned, the industry nationwide is about even now with what it was at the opening of the year.

Mr. HANNA. I want to talk to you about this nationwide average and then talk about the regions of the United States, because I think it is very important that we distinguish the sections.

Mr. HORNE. Yes, sir.

Mr. HANNA. If there are withdrawals that are in excess of deposits, then there is liquidity needs to meet those withdrawals, obviously.

Mr. HORNE. Yes.

Mr. HANNA. Fourth, there is needed money for operational expense every day that the shops are open, it seems to me, and fifth, there is money needed to pay interest rates if they are claimed by the depositors, right?

Mr. HORNE. Yes.

Mr. HANNA. All right. Where does the savings and loan get its liquidity to meet the demands? No. 1, is one of the sources the payment on loans?

Mr. HORNE. One of the sources would be that; yes, sir.

Mr. HANNA. You have indicated that that repayment is going to be down \$1.3 billion this year.

Mr. HORNE. The way things are shaping up, that is our estimate now.

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Mr. HANNA. No. 2, is another source of liquidity the sale of mortgages in the secondary market—is there any decline in the source of liquidity there, the sale of mortgages in the secondary market?

Mr. HORNE. There is a decline there; yes, sir.

Mr. HANNA. Would you say a portion of decline is reflected in the FNMA decision yesterday to move from $35,000 mortgages to $15,000 mortgage purchases?

Mr. HORNE. I am trying to think that through, Congressman, to give you an appropriate answer. You see, we are mostly in the conventional side of lending.

Mr. HANNA. I think you know the effects of the secondary market on the liquidity of savings and loans. It certainly has a strong effect, does it not?

Mr. HORNE. I would think it has some effect.

Mr. HANNA. Let me ask you this. Would you not agree with me that the secondary market is less salable today than it was a year ago?

Mr. HORNE. Yes, sir.

Mr. HANNA. So that is another thing?

Mr. HORNE. Yes, sir.

Mr. HANNA. No. 3, let me ask you again, there is a source of liquidity in new deposits, is there not?

Mr. HORNE. Yes, sir.

(Mr. Patman resumed the chair.)

Mr. HANNA. If you looked at statistics you would find there is a net withdrawal position in 1965 up to now? Are there sections of the country where this would be true?

Mr. HORNE. I don't know of any. I don't know of any. There may be. In your section, for example, the situation is about on par with what it is nationwide, that is the whole State of California.

Mr. HANNA. You would be impressed by figures from any substantial source that indicated that there was a net slide in position?

Mr. HORNE. Yes, sir, I would and I might also point out, Congressman, and this I think buttresses the point that you are making, that during the month of April as I indicated in my testimony, we did have withdrawals that caused some concern.

Mr. HANNA. It seems to me another source of liquidity would be the fees and service charges connected with new loans. Now, if they are making less new loans than they were making a year ago, they got less liquidity from that source.

Mr. HORNE. They are getting less money from service charges; yes, sir. This is flexible. In some parts of the country they are paid more—charged more fees, higher fees than in other parts.

Mr. HANNA. Let us take a look at the country as a whole. Is it not true that we cannot afford to simply be satisfied with the average statistics when we have so many demonstrable distinctions in the region which the savings and loan industry serves? Do you not have some responsibility for statistical analysis as to what the average is?

Mr. HORNE. I agree with the Congressman that you couldn't—that in determining all policy, that you have to look at more than just the national statistics, national figures.

I think the action of the Board would indicate that it has taken this into consideration in times past and most likely will continue to do so.

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Mr. HANNA. One final question. Are you anticipating going to the money market yourself to raise funds to operate the Home Loan Bank Board?

Mr. HORNE. We anticipate going to the market for whatever our money needs may be. For the information of the committee, no doubt you already know this, that when we and other Government agencies go to the market, we sort of operate through a traffic director, in this case, the Secretary of the Treasury. We have discussed our needs with the Secretary of the Treasury and are going to do so again in the next few days.

Mr. HANNA. In the event that you do have to go to the market and I believe you and I both agree that you will have to go——

Mr. HORNE. Yes, sir.

Mr. HANNA. You are going to have to pay the market price for money.

Mr. HORNE. This is right.

Mr. HANNA. And if I read it correctly in the Wall Street Journal yesterday, FNMA in its issue yesterday put out an issue at 5.45 percent interest and up 99.95 discount which figures at about 5.55 overall.

Dr. SCHWARTZ. That is what we expect to pay on the next issue, a coupon of about 5.5 is what we are thinking of now. A few days can make a change, but we don't think the change will be in the downward, though.

Mr. HANNA. I am in 100-percent agreement with you. I think also this has something to bear upon the questions that Mr. Widnall, Mr. Fino was asking, because I think that if we agree that the present programs have to be carried out, and certainly the function of the Federal Home Loan Bank Board has to be carried out to protect the $130 billion business that is involved here, you have to go somewhere for the money. And the price of the money is going to be a reality, whether it is in deposits or whether it is in borrowing, from the money market. It seems to me that it is true for all of these other programs we are talking about. If we are going to do it on the basis of direct loans, then we have to go to the money market to get the money for the Treasury to pay. If it is going to be by sales of participation, then we are going to have to go to the same money market and we are going to have to pay whatever the realities of that market dictate. Is that not correct?

Mr. HORNE. You are correct, sir.

Mr. HANNA. I thank you.

The CHAIRMAN. Mr. Hanna, do not overlook the fact that it would be possible for our Congress to compel the Federal Reserve to make money available to the Federal Home Loan Bank Board at a rate of interest that Congress felt was reasonable. Do not overlook that possibility.

Mr. Gettys?

Mr. HORNE. May I also make one further response in connection with the concern that Congressman Fino expressed and Congressman Hanna also touched on?

I think we bear in mind also, and I am not trying to be evasive in answering your question, Mr. Congressman. I am part of the administration as I am sure you recognize, sir. But I do want to emphasize the importance of management of this and I also want to

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emphasize that the amount of money that is affected here, I think in the first go-round is only about $4.5 billion and it will come from all sources, whereas the CD has presented a much larger figure than this particular participation program would and I just wanted to get that point in; that personally, I believe I am right, Mr. Chairman, it would be $4.5 billion involved and before any more would be involved, the administration would have to return to Congress.

The CHAIRMAN. 4.7

Mr. Gettys?

Mr. GETTYS. It is a pleasure to welcome an old Capitol Hill employee who has gone downtown and made good.

Mr. HORNE. Thank you, sir.

Mr. GETTYS. This whole subject has to do with competition for money; does it not?

Mr. HORNE. Yes, sir; to a great degree.

Mr. GETTYS. The fact that worries me somewhat is that the savings and loan industry is asking for authority, as I understand it, to go into other fields in addition to home loans. If there is a shortage in the home loan field, why would it be necessary—the shortage of money for the purpose that the savings and loan industry was created, why should it go into other fields which are now reserved to the banks on appliances, mobile homes, and that sort of thing? Is this a related subject?

Mr. HORNE. Yes, I think it is. Perhaps I should answer it this way: While Congress has by law made the savings and loan industry pretty much of a specialty in what it can do, it did not at the same time see fit to say to the commercial banking industry, for example, that it stay out of the mortgage market area. So the banks have complete freedom to go into almost anything whereas the S. & L.'s are restricted.

Now, as far as the immediate situation is concerned, you make a very good point. And this is a point that I was making to one of the members, Congressman Stephens, when he was commenting on the fact that we are looking very closely at money we are making available to some of the savings and loans through our central banking setup. We want to make certain that this money would be used for home purposes. But in the long run, I should think that it is entirely appropriate to permit the savings and loan associations, at least, to loan money on those things that go to make up a complete home and this is one of the things they are asking for.

As far as mobile homes are concerned, it so happens that now, about one out of every nine people that buys what he calls a home buys a mobile home. This within itself is a home and it can justifiably, I think, be argued that if they help finance the mobile home purchases, they are still in the home financing area.

I don't want to take all of your time, but there is one other comment that may be appropriate.

I don't know where the future is going to lead in this or any other industry, but I am rather of opinion that if Congress is going to insist that the savings and loan industry remain mortgage investment specialists, that Congress may very well have to provide other means for them to compete for savings. If Congress isn't going to do that, then Congress may very well have to permit—if the industry is to remain strong and viable—a more diversified portfolio than is now the case.

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Mr. GETTYS. Thank you, sir. Although it is an old-fashioned philosophy, are we not here asking again, either by law or by administrative action that the Federal Government should get more into the allocation or distribution among the competitive factors in the economy, private enterprise, dictating to them—are we not again in this legislation asked for here, going more into the private sector, putting the tentacles of the Federal Government into business and that sort of thing? Is that not another step in that direction?

Mr. HORNE. To enable the S. & L.'s to have a wider lending authority.

Mr. GETTYS. By legislative or by administrative decree, to say that this money has got to go here and this money has got to go there—that is interferring with competitive factors.

Mr. HORNE. This is a problem, Congressman. I frankly feel that Congress has already done so to a degree. It is something that can very well be defended, whichever point of view a person might have.

Mr. GETTYS. In the Old South where you and I are from, maybe the free-enterprise system is a little old fashioned, but I think we ought to consider it once in a while.

Mr. TODD. Would my distinguished, old-fashioned colleague yield? It seems to me you raised a very important point here and one which we should concern ourselves with. I wonder if what we are now discussing here is potential legislative action to offset administrative action which has already interferred in what Chairman Horne calls competitive allocation of funds. Is not this something that has already happened via an independent administrative agency which is charged with the responsibility of maintaining all monetary policy, the Federal Reserve Board, and are we not at this meeting simply discussing whether or not their action was wise and whether or not it took into consideration the impacts of that action on other financial agencies which Congress has established? So that we are now really at this committee deciding how funds should be allocated. We are deciding whether a decision of an independent administrative agency, wisely allocated funds in the money market. Would that be valid?

Mr. HORNE. This is certainly part of the picture, Congressman, no question about it.

Mr. TODD. I thank the gentleman.

The CHAIRMAN. Obviously, we are not going to be able to finish today. Can you come back tomorrow, Mr. Horne?

Mr. HORNE. I will be back whenever the chairman wants me to.

The CHAIRMAN. We will commence then with the gentleman next to Mr. Halpern.

We hope to finish with you tomorrow.

Thank you very much. We will be in recess until 10 o'clock tomorrow morning.

(Whereupon at 11:58 a.m., the committee adjourned, to reconvene at 10 a.m., Thursday, May 12, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, MAY 12, 1966

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, Stephens, Gonzalez, Weltner, Hanna, Grabowski, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Fino, Mrs. Dwyer, Harvey, Brock, and Clawson.

STATEMENT OF HON. JOHN E. HORNE, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD; ACCOMPANIED BY DR. HARRY S. SCHWARTZ, ECONOMIST, FEDERAL HOME LOAN BANK BOARD—Resumed

The CHAIRMAN. The committee will please come to order.

We will resume questioning of Mr. Horne. Mr. Horne has kindly consented to come back this morning so all members would have an opportunity to ask questions. It is possible, Mr. Horne, we will not use over an hour's time, something like that. I am just estimating. I know that would be pleasing to you because you are very busy and I thought we might be imposing on you, asking you to come back but we must give all our members a chance to interrogate.

Mr. HORNE. I understand, Mr. Chairman, and I appreciate your consideration and I will stay here as long as the committee wants to question me.

The CHAIRMAN. Mr. Brock?

Mr. BROCK. No questions.

The CHAIRMAN. Mr. Rees? Mr. Annunzio? Mr. Ottinger, have you interrogated Mr. Horne?

Mr. OTTINGER. No; I have not, Mr. Chairman. But I read this testimony.

The CHAIRMAN. You may go ahead, sir.

Mr. OTTINGER. I read your very fine testimony and want to congratulate you, Mr. Horne.

Mr. HORNE. Thank you, sir.

Mr. OTTINGER. Of the various approaches for resolving this problem, what seems the most promising from your point of view? I suppose you testified yesterday that you thought that the limitation of perhaps $25,000 as a floor on the deposits might be advisable. Are

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there any other steps that you feel would be advisable to rectify the problem?

Mr. HORNE. Congressman, on the top of page 5 of my testimony I alluded to other possible solutions. If I may, sir, I would just like to read that brief paragraph.

We would suggest examining the extent, in relation to total deposits, to which banks may use any of these instruments, negotiable CD's, nonnegotiable CD's, and time deposit open account. A minimum size limit for all these instruments and the appropriateness of multiple maturities and automatic renewal should also receive the committee's attention.

There are several points in addition to the size limit which I suggested and which also is suggested in your bill. Although my suggestion and yours are different, I should say that yours would certainly be helpful, even if you stop at $15,000 instead of $25,000.

Mr. OTTINGER. What degree of impact would there be between the $15,000 and $25,000 level? Do you have any idea of the amount of money that is involved in that range?

Mr. HORNE. No, sir; I do not have—I have not made an estimate as to the amount that would be involved. I should think——

Dr. SCHWARTZ. I think that estimate ought to come from the Federal Reserve because they are collecting data on this right now.

Mr. HORNE. I was going to suggest that the Federal Reserve Board could probably give you a better lead as to the amount of money that might be involved than we could. But I must say again that I think your estimate would be helpful, extremely so.

Mr. OTTINGER. How did you arrive then at the $25,000 figure rather than $10,000, which is the present insured limit, or the $15,000 figure which I selected because it is the one that is proposed as the limit for insured deposits?

Mr. HORNE. I must admit that I had no magic formula. It is just evident to us in our experience that the lower the figure is in CD's, the more effect it has on the thrift institutions. It just seemed to me that $25,000 or $20,000 or even $15,000 would alleviate to a great degree the pressure that is presenty on S. & L.'s and thrift institutions because of the current lack of any size of restriction.

Mr. OTTINGER. You indicate that you would like to see a restriction as to the percent of the total deposits of any institution which may be held in certificates of deposit. Do you have any idea what kind of percentage that would be and if there would be great difficulties in trying to administer that for all different kinds of banking institutions?

Mr. HORNE. I have not tried to inventory or research what might be an appropriate figure here. I suppose that it could be arrived at by the Federal Reserve Board. The Federal Reserve Board or the FDIC would be the appropriate sources to examine the banks as to what percentages presently exist in banks, and in cases where they think it is exceedingly heavy, it could be very well reduced and some maximum set. We have done similar things in the savings and loan industry as regards, for example, the amount of CD's that an S. & L. could hold in a commercial bank for which it would be given credit as cash. We ascertained by making a study in this particular area what we thought would be an appropriate amount, looking forward to the

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time of phasing it out all together. I think the Federal Reserve Board with the information that it would have on each individual bank and to what degree this practice is being carried on in each individual bank could without a great deal of difficulty come up with an appropriate suggestion.

Mr. OTTINGER. Would you be sanguine about giving the Federal Reserve Board discretion in both this regard and in regard to the amount of the floor that would be set, whether it would be $15,000, $10,000, $25,000?

The CHAIRMAN. Would you yield? Would you include in that the interest rate, too, that they would be payable?

Mr. OTTINGER. Yes.

The CHAIRMAN. Unless you fix it so that those under $25,000 would get as much as those above it, I think we would be placed in a position of discriminating against these small people and you would entice them into a situation that developed in the San Francisco bank where they were pooling their money and bringing it in there and they had a question raised as to whether or not insurance coverage was there. If we had something like a $25,000 floor, understand, I am all in sympathy with these savings and loans but at the same time we do not want to place them in a discriminatory position. If you say that below $25,000 that there would be a certain rate and that rate were below the rate on deposits over $25,000 that would help the thrift associations and the man with a lot of money, but it would be unfair to the ordinary citizen. I hope you give consideration to that in approaching this problem.

Mr. OTTINGER. I recognize that as a problem, Mr. Chairman, though I think it is rather more reflective of the situation that actually exists in the market rather than any discrimination that we would be perpetrating. I myself feel that the Federal Reserve caused this problem by permitting the CD's to come into being and to flourish so by changing regulation Q and permitting 5½ percent to be charged on it. I have some question about giving the Federal Reserve the discretionary power to resolve the problem. I am not sure they would properly exercise that discretion.

Mr. HORNE. If you should give them such power, as I indicated yesterday, you might very well wish at the same time to provide guidelines, either in the legislation or preferably in the report that the committee would make when it reported the bill.

I must say if I may, sir, that I have a great deal of sympathy myself with the position just expressed by the chairman. The committee might very well decide though that while this would be an evil in a way, Mr. Chairman, that there might be a worse evil if some restraint is not imposed here. I do not know the answer to it. I do say, again, that I am in sympathy with the thought that a person with a small amount of savings should draw as much as a person with a large amount of savings and yet there may be on a temporary basis some overriding reason that would cause the committee to want to put up with this sort of thing at least for a while.

Mr. OTTINGER. I think there is a much larger question here of imbalance between the regulatory agencies and the policies with respect to deposits that we will have to get at. But I am not sure, Mr. Chairman, that we should not solve this immediate threatening problem in

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a temporary way. Mr. Chairman, can I ask one more question, even though my time is up?

The CHAIRMAN. Mr. McGrath.

Mr. MCGRATH. I want to compliment Chairman Horne also for his fine testimony. It is always a pleasure for me to see him here.

Mr. HORNE. Thank you, sir.

Mr. MCGRATH. I am curious to find out, if it is readily available, what percentage of depositors in the savings and loan associations are also borrowers? Is that statistic kept?

Dr. SCHWARTZ. No, sir; the statistic is not kept.

Mr. MCGRATH. We will forget about it, then. Mr. Horne, is there any doubt in your mind that the Federal Home Loan Bank Board and other Government agencies have sufficient resources and statutory tools to keep things on an even keel and to deal with all contingencies in the savings and loan industry and other financial branches of our economy?

Mr. HORNE. I am very pleased that you ask that question, because I should like to try to dispel any doubt about it in the mind of anyone. There is no question in my mind but that with the resources of the Federal home loan banks, with the resources of other agencies on which we by law have the right to go to for assistance if need be, with the sympathetic understanding and concern that has been expressed to the Federal Home Loan Bank Board by appropriate officials of other agencies, the help that is being generated in case it is needed—I just do not believe that there is any reason for anyone to push a panic button and fear that we are about to suffer a real catastrophe. We have some trying times that we are going through; yes, sir. We have done so in the past and I am confident that with the sympathetic understanding and the proper working together of the congressional and executive branches of Government that we are going through this, too. I am pleased to say that I hope nobody will mistakingly take the position that the savings and loan industry is not going to be able to weather the difficulties that we are in now and that I am sure will continue for some months ahead.

Mr. MCGRATH. Thank you very much. I have no further questions.

The CHAIRMAN. Mr. Clawson?

Mr. CLAWSON. Thank you, Mr. Chairman. Mr. Horne, in answer to a question yesterday, you indicated there was no prohibition on certificates of deposit in connection with the savings and loans. However, they have exercised, apparently under your direction, extreme caution in the use of this instrument as part of their procedure. Is that about the way you put it?

Mr. HORNE. We have, Congressman, what is called not a certificate of deposit, but a certificate. We think that on the whole, the savings and loans have exercised this authority with prudence. As a matter of fact, it has only been in recent months—relatively recent months since I came to the Board, since I became Chairman, as a matter of fact, that we worked out a certificate program that would be made available to the savings and loan industry. We have presently under study further steps in this direction. We hope to have it formalized in a very few days.

This is for the modification of certificate programs that can be used by the savings and loan industry. If I understand your question correctly, this is a responsive answer.

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Mr. CLAWSON. To the extent that you have explained the certificate. You indicated that they do use something comparable to the CD in the S. & L. industry.

Mr. HORNE. Yes, there are some differences. There are differences in the legislation and regulation under which banks operate and under which S. & L.'s operate. There is some difference between these two instruments. But we have felt for some time that there was a necessity for savings and loans having, at least as a defensive measure, some such device. Several months ago, we developed such devices and as I have just said, we are now in the process of even revising these devices.

Mr. CLAWSON. I recall that some 5 years ago or longer, I deposited with a savings and loan, something comparable to CD. What would that have been at that time?

Mr. HORNE. I frankly do not know, sir.

Mr. CLAWSON. This was a certificate. It was not a passbook.

Mr. HORNE. I do not know that it would have been the old bonus plan that has been part of the regulations for some time. There is a bonus plan wherein S. & L.'s may pay a bonus if the money is held for a period of 3 years of up to 1 percent. We modified that a few months ago because some did not want to have to pay the full half percent and we gave them flexibility so they could take an eighth, a fourth, or a half. That is what you may have in mind as far as Federal is concerned. As far as States are concerned, as you know, we have the dual system and sometimes the State permission is not exactly what the Federal regulation may be. I believe Dr. Schwartz may comment on this.

Mr. CLAWSON. I think mine was a State association certificate.

Dr. SCHWARTZ. If it was a State-chartered association, you may have a special situation.

The Board does approve each certificate that is issued if it is for a fixed term or has a fixed rate. Now, there is authority in the Federal regulations and there may be in certain State regulations to issue a certificate in lieu of a passbook. There is no difference in that case.

Mr. CLAWSON. I did not know the bonuses that I received were for that purpose.

Dr. SCHWARTZ. I think you got that for opening of the account.

Mr. REES. Will the gentleman yield? I had a bill on giveaways and premiums. There are no more giveaways.

Mr. CLAWSON. In your statement on page 4, you also indicated that with the use of CD's, by banks, they are building a liquidity squeeze for themselves if they pursue this too far.

Would you want to enlarge upon that comment?

Mr. HORNE. Well, my own reaction is that these CD's of course mature and when they mature there is a question whether they are going to be held or whether they are going to move out into other channels. If too much of the bank holdings is involved in this kind of savings or deposit, it can of course, create a greater problem.

I do not know, because I am not privy to all the problems that the Federal Reserve Board may have experienced last December. But my assumption is that this was part of the difficulty that the Federal Reserve Board faced even at that time. As the amount of holdings of CD's in a bank increases, this problem can continue to expand.

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Mr. CLAWSON. I wanted to ask one more question. May I indulge just for a moment? There have been statements made that the liberal and expansive attitude of the Federal Home Loan Bank Board in the past, 5 years ago, together with the dramatic growth and expansion of the savings and loan industry, contributed to some extent to the present situation by encouraging their liberal loaning activities. Do you want to comment at all on that?

Mr. HORNE. I would be very glad to, Congressman. I read a story some time ago which said that the hindsight of an elementary school graduate was superior to the foresight of a Ph. D, and to some degree this perhaps is right.

I would not doubt on some occasions we may have been a little bit too generous in permitting savings and loan associations to borrow from their respective Federal home loan banks.

This is a problem that we constantly face. Many of the associations think on the one hand, and perhaps erroneously so, that they have the right to go to the window and borrow whatever they think they need. We have in several very important ways imposed some restrictions during the past year or 18 months, and frankly it has made some of the members unhappy. But I think we have done wisely in imposing some restrictions. And it would be my intention, if I am still on the Board, to look at this thing even more carefully in the months and years ahead once we get through the present situation.

On the other hand, I must—in answer to your question—tell you of a bit of correspondence that took place between the Board and a State supervisor a few weeks ago. The State supervisor said that the problems of the State associations in his particular State, that is their problems having to do with the scheduled items and foreclosures and delinquencies and overbuilding should really rest on the shoulders of the Federal Home Loan Bank Board because these associations have not only advertised excessively for out-of-State money with high rates, but that we have in addition permitted them to borrow money from the district bank. And I responded by telling him that he may be partially right in his criticism of the Board, but I should like to point out that he is also saying, as regards associations under his supervision, that they are not to be trusted to determine how much money they should get from different sources and that they do not know how to invest wisely the money that they do get and this might be somewhat of a reflection on the State supervisory functions as well as a possible reflection on the Federal Home Loan Bank Board.

Mr. CLAWSON. Thank you. My time is up.

The CHAIRMAN. Mr. Hansen?

Mr. HANSEN. Thank you, Mr. Chairman.

Mr. Horne, what percentage of the holdings in the savings and loan business are comprised of the federally insured items such as Federal housing and FHA loans?

Mr. HORNE. I will supply the exact figure on that just to be certain. I believe I am right in saying that it is around 96 or 98 percent. Now this is true savingswise. It is not true numberwise. There are quite a few savings and loan associations that do not have their accounts insured, but they are usually small associations. Not always, but usually they are small associations. So between 96 and 98 percent, and I would like to—when I read my response put in the exact figure so as to answer your question correctly.

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Mr. HANSEN. Are you talking about the mortgages they hold?

Mr. HORNE. No, sir; I am talking about the savings.

Mr. HANSEN. I am talking about mortgages in their portfolio.

Mr. HORNE. You are talking about VA and FHA. This is only 10 or 11 percent, sir.

Mr. HANSEN. Ten or eleven percent?

Mr. HORNE. Yes, sir.

Mr. HANSEN. Someplace along the line you were drawn into some discussion about the participation sales bill in the testimony that took place yesterday, and the allegation was made, I believe, by someone, I am not sure whom, that the sale of participation certificates compete for mortgage money and therefore withdraw this money from the market. In the Wall Street Journal on May 6 there was a long article about increased activity on the part of FNMA, picking up insured mortgages from the industry. In it there is a sentence which reads as follows: "When Fannie Mae buys mortgages it provides lenders with fresh cash to reinvest in other mortgages or in new construction."

Now presumably these mortgages that are being sold to Fannie Mae are those that were bought or taken at a lower interest rate. To the extent that they are buying these insured mortgage loans from the private institutions and institutions such as the savings and loans they are doing some subsidizing in taking care of the difference in interest. Fannie Mae is reported to have sold $400 million worth of their debentures at 5.45 rate basis. Now, wherein is the difference between this procedure and permitting the Federal agencies to move their paper through the same route? I know that this is not germane to the bill that we are discussing here today, but it is a question which was raised. Therefore, I think, the matter should be pursued a little further.

Mr. HORNE. Well, I suppose, if I understood the mechanism correctly, Congressman, there is no real difference. Ever since I have been in Washington, since 1947 to be exact, Congress from time to time has enabled Fannie Mae to carry out some functions to give assistance to the homebuilding industry. I should like, if I may, sir, and I think this would be a partial response at least to your question, comment somewhat further on the participation program that Congressman Fino asked me about also yesterday. I frankly admitted that I had not studied the situation in depth, although I was generally familiar with it. But since he asked me that question I checked further into the program and there are some comments I think that might be appropriate both to your question and to one that Congressman Hansen has just asked. After I looked more carefully into it, the participation program is not one that would greatly affect the flow of savings into the savings and loan industry or into thrift institutions. My conclusion for this is related to the fact that the sales by the Government would amount, under existing proposals, to about $4.5 or $4.7 billion. The certificates which have been sold heretofore have been in units of not less than $5,000. I believe the Treasury in testimony has indicated, they would be willing for the amount to be higher.

These sales would substitute private credit for public credit and if the Government did not sell the participation certificates it would have to sell Treasury obligations. These would have at least a similar effect on the market that the participation program would have. The

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Government sale of participation goes across the entire investor field, as I pointed out yesterday, with emphasis on large investors, and this is quite different from the great amount of money that is going on in small CD's. Investors who buy the participation instruments would be more likely to be using them as a substitute for other types of market securities rather than as a substitute for savings accounts. And so I have not concluded in my own mind that either the participation program or the Fannie Mae part of it, as presently being administered, would constitute any great additional strain, if any at all, on the flow of money into the savings and loan associations or the mortgage market. There might be some, of course. I do not think anybody could say there would be nothing whatsoever. But I think the effect, if any, would be minimum.

Mr. HANSEN. Thank you very much for clearing up that point, Mr. Horne.

The CHAIRMAN. Mr. Annunzio?

Mr. ANNUNZIO. Thank you, Mr. Chairman, Mr. Horne, I, too, along with my other colleagues, would like to commend you on your excellent presentation.

Mr. HORNE. I appreciate that.

Mr. ANNUNZIO. I would like to express our thanks for your contribution in helping us to solve the CD problem before the committee.

I would like to get back to the participation pool, because it is, as far as I am concerned, germane to the question before us, for the simple reason that we are discussing liquidity on the part of our banking institutions and what effect it would have on the effect of the liquidity of the banking industry.

Mr. Horne, would you not agree that, first, the shares sold in the participation pool need not cost the Government 5½ percent since the rate depends on a number of factors which generally change?

Mr. HORNE. This is true, sir.

Mr. ANNUNZIO. If the pool taps funds from a number of sources, such as pension funds, large investors, insurance companies, and others, it need not compete with availability of funds for housing.

Mr. HORNE. Yes, sir.

Mr. ANNUNZIO. Would you say yes to that?

Mr. HORNE. Yes.

Mr. ANNUNZIO. Would you not agree, just as with this issue of CD's, that the issue before us is how CD's affect the savings and loan industry, depending on the size of the denominations issued by the pool? In other words, the denominations issued by the pool may not in any way compete with flow of funds into thrift institutions.

Mr. HORNE. I agree, sir, and I also made a similar point in the comments that I just made with regard to your question.

Mr. ANNUNZIO. I would also, Mr. Chairman, like to read one paragraph of an article that appeared in the American Banker on May 9, and then ask unanimous consent that it be inserted into the record.

The CHAIRMAN. Without objection, so ordered.

Mr. ANNUNZIO. It deals with the Continental Illinois National Bank & Trust Co., in Chicago, which a week ago suggested that passage of the bill to sell Federal loan assets might unsettle the financial markets and over the weekend said that failure to pass the bill would increase the size of the budget deficit and impose even greater pressures for fiscal restraint.

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I would like to have this included in the record at this point.
(The article referred to follows:)

[From the American Banker, May 9, 1966]

CONTINENTAL ILLINOIS ASSERTS PASSAGE OF ASSETS BILL IS LESSER OF TWO EVILS

CHICAGO.—Continental Illinois National Bank and Trust Co., which a week ago suggested that passage of the bill to sell Federal loan assets might unsettle the financial markets, said over the weekend that failure to pass the bill would increase the size of the budget deficit and impose even greater pressures for fiscal restraint.

The measure, known as the Loan Participation Act of 1966, calls for sale of $8 billion of Federally-owned assets by June 30, 1967. The bill cleared the Senate Thursday and a companion measure has been approved by the House Banking and Currency Committee.

The bank pointed out in its government bond department's weekly publication, Continental Comment, that sale of the assets is reflected on the government's books as a net reduction in expenditures, rather than as an increase to receipts.

If the bill should fail to pass, says Continental, "then pressures would develop to increase direct Treasury borrowings, raise taxes or reduce other expenditures."

Direct Treasury borrowings would be restricted to the shorter range of the market because of the 4¼ percent ceiling on long-term governments, the publication states.

The tax increase alternative continues to be played down by Administration officials, while a reduction in spending faces stiff political opposition, Continental adds.

"Perhaps most vulnerable to spending reduction are those programs related to the Great Society where expenditures are rising rapidly," the bank declares.

"Yet each specific area of this program already has its advocates disappointed that the cost of the war has held back funds which otherwise might have been available to them. In fact, Congress recently has restored funds to many areas where proposed reduction had been suggested.

"Perhaps the simplest solution would be to have an across-the-board reduction in nondefense spending."

The bank concludes that the proposed sale of assets "has important implications for the future course of the economy," with particular impact on the budget.

Mr. ANNUNZIO. Mr. Horne, also in your testimony, I recall that when the discount rate was increased, you said there was no consultation between the Federal Reserve Board and any of the supervisory agencies in the Government like the Comptroller of the Currency and yourself?

Mr. HORNE. I do not know, Congressman, to what degree they may have consulted with other agencies of Government. But as I answered the question yesterday, they did not consult in advance with the Federal Home Loan Bank Board.

Mr. ANNUNZIO. Thank you, Mr. Horne. I also recall you stating that on January 6 a committee was formed for the purpose of discussion.

Mr. HORNE. Yes, sir. I would like to stress this point if I may. I am sure the committee members remember that in the closing months of President Kennedy's sojourn as President, he suggested the formation of such a committee. Well, shortly after President Johnson became President he instructed the Secretary of the Treasury to make certain that such a committee was formed. Such a committee has been formed. It is functioning. We do not announce to the press or give any publicity to the fact that we meet, but we meet fairly regularly. There is, in my opinion more exchange of information now between the regulatory Government agencies in the field of financial institutions than there has ever been in the past. In addition to fairly regular meetings of the Chairman of the Fed-

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eral Reserve Board or the Vice Chairman, the Chairman of the Federal Home Loan Bank Board, the Chairman of FDIC and the Comptroller of the Currency, there are special meetings on topics that would be of interest to all of us between times. So there is now consultation going on, close consultation.

Mr. ANNUNZIO. Would you say this consultation has increased since December of 1965?

Mr. HORNE. Yes, sir; it has. I was going to say——

Mr. ANNUNZIO. I am very happy that after the horse has left the barn some of our people in the supervisory agencies have decided to talk to each other. Thank you, Mr. Chairman.

The CHAIRMAN. May I suggest, Mr. Horne, that sounds mighty good, but if the President himself organized this coordinating group, then they would all be obligated to the President to make sure they did a good job and he would be the overseer. But now, then, you have a coordinating committee composed of members all in a comparable position, no one above the other, and I think that is the weakness in it. I hope the President would organize a coordinating committee himself. Do you not think that would be more effective?

Mr. HORNE. This may partially be what you have in mind, that the President has, in effect, done this through the Secretary of the Treasury.

The CHAIRMAN. I do not agree with you at all, Mr. Horne.

Mr. HORNE. You may be right, Mr. Chairman.

The CHAIRMAN. If the President did it is one thing, but for him to suggest one who is in a comparable position to get everybody together, I think that is entirely different. I would like to see the President in charge of it. He is elected by the people and I think we should have some way of him being in charge of it.

Mr. HORNE. My only intention was, Mr. Chairman, I do not know whether or not the committee recognized that while the President has not done exactly what you are suggesting, he did ask the Secretary of the Treasury to put it together and to stay on top of it and we report regularly to the Secretary of the Treasury.

The CHAIRMAN. But you still have no power and authority to oppose the Federal Reserve. They have determined to be a fourth branch of the Government. You cannot do a thing about it.

Mr. HORNE. To give a candid answer to your question, sir, we do not have the authority to override the Chairman of the Federal Reserve Board.

The CHAIRMAN. Mr. Harvey?

Mr. HARVEY. Mr. Horne, I am sorry I had to leave yesterday after your statement. You certainly have had a very distinguished career in Government and we welcome you here as a witness.

Mr. HORNE. Thank you very much.

Mr. HARVEY. I have just a couple of questions here.

First of all, do you support this bill, H.R. 14026? That is the chairman's bill which would in effect prohibit the issuance of negotiable certificates of deposit.

Mr. HORNE. May I make two comments in response to your question, sir?

I forgot yesterday to point out that I am testifying largely on my own in that we did not have time for what I have said to be checked

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with the Bureau of the Budget which is the customary channel for Government agencies to use. I did want to clarify that since I forgot to do so yesterday.

Now as to this bill, H.R. 14026, I tried to make clear in my testimony that, while I am not in opposition at all to H.R. 14026, it is not the negotiable CD's alone that are causing us difficulty in the savings and loan industry. The nonnegotiable CD's are also a problem that gives us some concern and that in very recent months, the nonnegotiable CD's have, in quantity, outgrown the negotiable CD's.

Mr. HARVEY. Let me ask you this next question. Would you support flat prohibition of negotiable certificates of deposit?

Mr. HORNE. Before giving a direct answer to that question, I would want to give a little bit more thought. I think I can say again, I have no objection to it, but I do not think it would solve the entire problem we are driving at.

Mr. HARVEY. My reason for asking that, Mr. Horne, is that I am sure some of us feel that is a very drastic approach to the problem and on page 5 of your statement you did not outline any course similar to that. My offhand reaction to it, when I saw the bill the other day is that it would cause chaos in the market.

Mr. HORNE. In deference to the Chairman—I have not discussed this with him previously—I am not convinced that this would cause chaos or that this alone would solve the problem. I think to get at the problem that is giving us difficulty now, Congress would have to go further than just deal with the negotiable CD's.

Mr. HARVEY. Let me ask you another question in another area, which shows my ignorance of the savings and loan industry rather than anything else. In my area in the State of Michigan, the home loans from the savings and loans are going at very high rates of interest, 6½ and 7 percent is what they charging a home loaner for a loan. Yet, the interest being paid on deposits very frankly is still 4, 4¼ percent which leaves a very substantial spread between the interest paid on deposits and the interest paid by the borrower. I used to think that something like a 1½-percent spread or something like that, certainly 1¾ is enough to allow an ample profit. But apparently the spread here is as much as 2½ percent or more, 2¾ percent. Does this enter into the picture at all, what the charges in the market will bear? Would you have any comment on that?

Mr. HORNE. Yes, sir. I think there are several comments that would be appropriate.

In the first place, generally speaking, 1½- or 1¾- or 2-percent spread should be adequate with a well-run savings and loan association. I do not have the latest figures as to what is happening in the State of Michigan, and if it would be of interest for you, sir, for us to get the figures as to what the savings and loans pay to savers, I would be very glad to supply them for you because we could get that information. I think you would find that the actions by the Board of Governors in November 1964 have to be kept in mind. I believe the 1964 action caused some upward pressures on the rates S. & L.'s pay savers. And these two steps put together, particularly that in January 1966, I believe would show that the S. & L.'s in the State of Michigan are paying more for their savings than they were paying. I think you will find that perhaps some of them now are paying 4½

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percent. You would also probably find that some of them—perhaps not a great number—but some of them are using the certificate plan we have in which they would pay 4.75 percent. So these are two factors that come into it.

(The information referred to follows:)

Michigan Savings & Loan Association members of Federal Home Loan Bank System anticipated regular dividend rates for period beginning Jan. 1, 1966

Anticipated dividend rate:	*Number of associations*
4.50 percent	4
4.26 to 4.49 percent	2
4.25 percent	39
4.01 to 4.24 percent	3
4.00 percent	17
3.50 percent	1
No information	2
Total	68

Mr. HARVEY. One other question, a simple one: In your career have you ever known a rollback in interest rates? This is what frightens me about this 6½ and 7 percent. In my memory I cannot remember these interest rates going back, rolling backward.

Mr. HORNE. Yes, sir, they have gone back. Here is what can happen. I was going to make one more comment, if I may. There is a shortage of money today. The S. & L.'s are under a squeeze to pay more money if they are to protect even the savings they have. In anticipation of having to increase rates again that they pay to their savers they are probably taking advantage of the fact that money is short. Consequently, they are picking and choosing carefully the loans they do make, and are charging a higher rate because they may themselves have to pay a higher rate for money in the future unless we can control the matter some other way.

Now, there has been a rollback and this has happened time and time again. This will work very well in Michigan or any other place if they get out of line. Once money starts flowing into thrift institutions and business demand for credit declines, lenders won't be able to get what they can today. The people who are now being charged 6, 6½, or 7 percent can very well come in and refinance their loans and get the lower rate, whatever the low rate at that time may be. This has been done quite frequently in this industry. So if they get much out of line, once the cost of money is less, they will be brought back into line.

Incidentally, there is one thing that would be of interest to the committee. Federal associations actually have the authority today, when they make a loan, to put in the contract that they could raise their charges to the borrower along the way if they wanted to. But very seldom does one include this in the contract because there has been such competition in the home mortgage market that he hasn't been able to impose it. If he tries to impose it the borrower can go to an insurance company or a bank or some other source and get his loan that would not have such a mathematical clause that would enable the lender to charge him a higher rate on his loan.

Mr. HARVEY. Thank you very much, Mr. Horne.

The CHAIRMAN. Mr. Rees?

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Mr. REES. Mr. Horne, I would like to look at this instrument that we call a certificate of deposit. The original use of the CD was for an investment where a corporation could use its excess funds, they would go into a CD for a specific period of time and earn interest on their excess funds which they could not do in a savings account in a bank. Was not the original CD for about a 1-year period? What worries me is not so much putting a floor on the certificate of deposit but trying to analyze what a certificate of deposit is and then deciding, is this good or bad for the banking industry? In California we have had probably more trouble with banks than savings and loan institutions. One of the problems in California, especially with newer banks, is that in an effort to build the deposits up to new records, and we like to do that in California, they went through money brokers and purchased a lot of CD's and unfortunately these CD's came up for payment at the same time. The bank found itself in the difficulty in terms of liquidity. We had quite a few mergers because of this. You find the CD in a way is a very dangerous instrument. They say the CD crisis in New York in December was what led to the increase by the Fed to rediscount rate and increasing the interest rate for the CD's.

I see that you have authorized the same type of gimmick, or whatever you want to call a CD, for savings and loans and so now we find two different types of concepts, one is the passbook concept and the other is the certificate of deposit. They are really the same except a few internal changes; they are really the same. Do you not think it would be better to eliminate the certificate in the savings and loan and go back to passbook and then to regulate perhaps the bank CD in terms of the use by the banks so that the CD does what it was supposed to do originally, which was to give an interest-making haven for large funds of corporate money, therefore you would not have the suicidal competition between the banking systems? What about the approach of not outlawing them or not building a dollar limit on them but saying a bank CD must be an instrument held for at least say 1 year and the interest paid can be no higher than the interest paid, for example, on a passbook. In this way I think you would cool down this competitive race for this type of money and you would leave the CD where it was supposed to be and at the same time you could get rid of these certificates which really are not going over very well in California. What do you think about this approach? Do you think this would have the tendency to cool this whole situation down?

Mr. HORNE. If it can be done—as a matter of fact, the suggestion appeals to me very much, Congressman, and this may be a very good way to do it. I think you would have to weigh how long you took and under what condition you could shift into the kind of program you are talking about. Of course, possible overloading of CD's in banks is one of the reasons that in my testimony I suggest the committee give some consideration to the proportion of bank savings that could be in the form of CD's. Because the problem could get out of hand just as you have indicated. Your solution might be a very good solution to it.

So far as the certificates in the savings and loan industry is concerned, there is only a small similarity to what has been done and what is being done in banks. The savings and loans are much more conservative under our restraints.

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It should be pointed out—I am sure they can point it out better than I, that the Federal Reserve Board is concerned about the difficulty. They have expressed concern as to what effect it might be having on thrift institutions. I have been very pleased that some of the bankers themselves are concerned about the situation. I know that the president of the American Bankers Association, Mr. Davis, from North Carolina, has been very outspoken in this regard and has expressed grave concern that the present use of CD's in unlimited quantities and unlimited denominations can cause difficulties not only to the banks but also to the thrift institutions.

Mr. REES. They are so concerned, they are ready to cry all the way to the funeral, are they not? I think there are very serious problems in California and unfortunately it is wholly the fault of the industry as they are generally in a very sound condition in California. In terms of a long-term viewpoint, we see this problem where the decisions of another Board directly affects your industry. The direct problems that the savings and loan industry is having today, especially where there is a need for new money for mortgages is directly attributable to the December action of the Federal Reserve Board. Do you think that one of these days we might be able to look at the overall problem of the money market in the United States and have some coordination? Why could we not make you an ex-officio member of the Board and let you veto anything that the Board comes up with and that might affect your industry and Mr. Martin could be on your Board ex officio and do the same thing? There is no use for you to swallow the ball when it is another Board that is affecting you and directly affecting you and putting you probably in the worst crisis you have had in a great many years.

Mr. HORNE. I hardly know, Congressman, how to respond to your suggestion except to say something I said yesterday. This industry has become of such magnitude and of such importance that unquestionably it is going to rightfully receive more attention than was the case 15 or 20 years ago when what might happen to it did not—could not have the impact on the economy it could today. So, some device, whether it is voluntary or otherwise, has to be used to make certain that whatever is done as regards one structure of financial entities is done in a way and in a manner that does not visit great harm on the other.

Mr. REES. Mr. Horne, my last question. The situation in California, and I do not know it in other States, and I think we would tend to have the same situation—in California the person who keeps money in the savings and loan institutions is primarily an investor. It is not Joe Doakes around the corner who has a couple of hundred dollars. And looking at the larger associations, and this probably is the same in the smaller ones, the average account tends to be around $9,000. If we look at the type of account that has been withdrawn and put into CD's or municipal or other competing types of paper, we find that the average is again around that $10,000 level, the level to which you are insured. We find that this is directly affecting the homebuilding market in California. The homebuilding construction is perhaps the largest industry we have and we are already having layoffs. We find that it is a serious situation in terms of real estate as people cannot sell their houses or buy new houses because of the problems of trying to

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find mortgage money and this is through no fault of the financial institutions themselves. You are the Chairman of the Board. What do you plan to do about this situation that I think is a serious one for the overall California economy?

Mr. HORNE. Congressman, as I have indicated earlier in my remarks, we have been studying this for some weeks. I believe either tomorrow or before the end of this week, or certainly next week, we will make our announcement of some of the things we are going to do.

I would not want to mislead you into believing, and I know you are not attempting to get me to do so, that through the bank window, so to speak, we are going to be able to supply money to the California associations for all homebuilding purposes.

Mr. REES. What if they do not want to be supplied money? What if they would like to have the competitive tools and go out in the free market? Why should they have to go back to your bank and draw down the funds? Why should the Government go out and float more loans to build up these reserves if really the whole solution might be the use of the free market in allowing these institutions to compete just the way the banks are competing today. The banks are paying five and a half percent now in California for CD's, as little as 30-day terms, and in CD's for less than $100. Now, you know that is not a CD. I know it is not a CD, but that is what they are doing and the Federal Reserve Board seems to say it is OK. Are you going to give the banks, the savings and loan institutions in my State and throughout this Nation the right to compete in the open market for funds?

Mr. HORNE. Let me perhaps try to respond in about two or three different ways. To alleviate in some degree the problem that you describe, Congressman, I am not sure that one needs to go as far as you have indicated.

Secondly, we still have, and this is not necessarily true only of California, but we do have in certain places in California a surplus of housing. Two other things that bother me frankly, and I indicated this also yesterday, is that the S. & L.'s have their money tied up in long-term loans and there is a limit to how much they can pay across the board for their savings and at the same time earn enough money to meet all their requirements. Then we do have this situation which I think is to some degree a supervisory or regulatory agency has to keep someone in mind, and that is, whenever one association takes a move, just brings pressure on every other association to do a similar thing. It is true that some of the larger, more powerful associations can do a little more in the way of ratepaying than some of the smaller ones can. The argument can be made both ways.

On the one hand, there is the argument that each association be allowed to pay whatever he desires without any regard for the adverse effect it might cause on his neighbor. On the other hand, we are sitting here with a limited amount of money in the Insurance Corporation—and we have to give some consideration to the adverse effect that may be visited upon a somewhat weaker, somewhat newer, a somewhat younger association.

Mr. REES. It sounds as if you wanted to use the insurance instrumentality as the main shoring up of the market in California. Do you not think what California needs is more mortgage money, and

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do you not think they need some kind of competitive tool? What about some kind of competitive tool allowing them to go in the open market and do some bidding? They are 0.65 percentage point behind the banks now in terms of competition.

Mr. HORNE. I made clear one of the things we will do, will give some relief in the situation—I should point out, and I have too much respect for you, Congressman, to disagree with you——

Mr. REES. Please.

The CHAIRMAN. We have some other members who have not interrogated the witness at all. Would you mind withholding until they have?

May I make this suggestion? I am afraid we are overlooking one important point.

You know, the Government has often restricted the use of money for different things like savings bonds. They used to have to restrict that to $10,000, certain types of bonds, which is perfectly all right. It is in the public interest. It protects the public. In this case, and you know, it was not permissible for corporate funds to be used on savings accounts in banks. That was a good idea, because that induced the corporate funds to be in competition with all the others and keep interest rates down for the public. A specific example of this is interest rates on short-term Treasury securities. When they were using those funds in bidding for short-term Treasury bills, the short-term interest rates were held way down. But when they left that market and went into the CD's, then the short-term rates went up and they are still way up there now. And then by inventing this CD device and letting these corporate funds be used this way, that is really like an evasion of the old policy of not permitting corporate funds to be used in savings. This money is just too volatile, too sensitive to interest rate changes. They are used in time deposits, but they had to make another step in order to be effective. They had to make them negotiable, then they had to create a market for them. That is like paying interest on demand deposits and it was a revolution in the banking world to the extent that it gives a few people an opportunity to create higher and higher interest rates for themselves because those firms are out of the Treasury bill market when they ought to be in it.

I am afraid that we have ignored that particular point in our own looking at the CD problem.

It is a revolutionary change in the entire banking system imposing upon the public higher and higher interest rates. Do you not see something of that, Mr. Horne?

Mr. HORNE. I think unquestionably some of the things you have outlined have taken place, Mr. Chairman, in the way CD's have begun to be used.

The CHAIRMAN. Mr. Weltner has not interrogated, neither has Mr. Todd nor Mr. Grabowski. These three gentlemen have not. We will yield to them now.

Mr. WELTNER. Thank you, Mr. Chairman.

Mr. Horne, I am sure you are familiar with the situation in the metropolitan area of Atlanta. Since the first of the year, savings and loan institutions in that area have suffered a loss of about $30 million in loss of accounts.

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This has resulted in the drying up of mortgage money and as I understand your statement on page 5, a continuation of that would bring mortgage availability to "intolerably low levels." Does that situation hold pretty true throughout the country?

Mr. HORNE. To a great degree; yes, sir. I want to point out something that I pointed out yesterday which has a bearing on this question, Congressman.

Taking the industry as a whole, comparing what it was on January 1, 1966, and what it is today, the net inflow and outflow of savings, that is the total amount of inflow and outflow is about even. Now, this may interest Congressman Rees. Taking the State of California as a whole, comparing what the situation was on January 1, 1966, through April 1966, the S. & L. industry is down in California by $24.5 million.

(The chairman, Mr. Patman, left the hearing room and Mr. Reuss assumed the chair.)

Mr. HORNE (continuing). So we have not had quite the reduction in the flow of money within the industry since the first of the year that sometimes we think.

Mr. WELTNER. The situation in Atlanta then is substantially more drastic than the situation elsewhere; is that correct?

Mr. HORNE. More drastic than in some places, no more than in some others.

Mr. WELTNER. The availability of mortgage funds are substantially adversely affected by the widespread use of certificates of deposit; are they not?

Mr. HORNE. In Atlanta, yes, sir; this is true.

Mr. WELTNER. Those CD's which are causing the great trouble to the availability of mortgage money are what are sometimes called consumer CD's, $2,500, $5,000, $7,500?

Mr. HORNE. Yes, sir.

Mr. WELTNER. In California you have authorized Federal savings and loans out there to issue some kind of savings certificate or some kind of instrument similar to negotiable CD, and I assume that that was done in an effort to permit a greater degree of competition with the CD's offered by banks.

Mr. HORNE. Yes, sir.

Mr. WELTNER. I understand also that there is under consideration by the Home Loan Bank Board the requests from several area associations for similar authorization on the part of the Home Loan Bank Board.

Mr. HORNE. That is correct, sir.

Mr. WELTNER. I think you said you had this under consideration and possibly this question could not be properly answered at this point, but would seem to be a perfectly reasonable thing as a step of equalizing competitive opportunity—not quite so far as a step as eliminating the issuance of CD's by banks.

Mr. HORNE. First, we have in the past, Congressman, given the S. & L.'s defensive measures to enable them to do this. We have under consideration other defensive measures that would enable them to do this. I think the people in Atlanta will probably be satisfied once we come out with what we have in mind.

I should also like to go a step further with the fear of Congressman Hanna and Congressman Rees may be having something to say

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about it and point out that it has been traditionally so that in the State of California and one or two other places in the Far West, adjacent to California, that they have always advertised in eastern markets and otherwise advertised higher rates and used more devices to draw in money.

I must say in all honesty I have not always been in accord with some of the things they have done and this is part of the difficulty—this accounts for some of the difficulty that we experienced today. But even so, there is less differential between what is available in California and what is available in other parts of the country today than there was 18 months or 2 years ago. But I think for some period of time we will have to make some special allowance for the situation that has developed in the State of California as compared to the situation or the difference that exists in California as compared to the rest of the country. I did want to get this point in because I think it is pertinent to the entire situation. But again, specifically, as to Atlanta, I have had a great deal of correspondence as you can imagine from different sources as regards the situation in Georgia and the practices of one or two of the commercial banks—one in particular—and we have taken this into consideration in the defensive measures that we are advocating, and I think, we in effect, are proposing something that will be even a little bit more defensive, more effective than your associations have recommended.

Mr. WELTNER. Thank you, Mr. Horne. Thank you, Mr. Chairman.

Mr. REUSS. Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

Mr. Horne, I appreciate your comments and we welcome them.

On page 2 of your testimony yesterday you indicated that there has been a loss of about $550 million in savings from S. & L.'s against a net outflow in April 1965 of less than $100 million last year. This is an increase in the net loss this year of $450 million which I take it you attribute to the CD practices of the banks.

Mr. HORNE. To some degree; yes, sir.

Mr. TODD. To some degree. Would 50 percent be accountable to the CD's?

Mr. HORNE. I should think at least that.

Mr. TODD. My next question—this does not appear to follow at the moment—if I deposit $100 in an S. & L., how much of that can they loan out? Can they loan out $90 or $100? Do they have a reserve requirement against that?

Mr. HORNE. We have a reserve requirement in the savings and loan industry that varies from association to association, depending on certain factors. But in answer to your question, I should think you could loan the entire amount or most of the entire amount.

Mr. TODD. But they could not, as the banking system could do—the banking system as a whole could do. If I put $100 in a savings deposit, they could loan out 25 times that or $2,500.

Dr. SCHWARTZ. I think you got too big a multiplier.

Mr. TODD. There is 4 percent reserve ratio required.

Dr. SCHWARTZ. That is not quite the way it works.

Mr. TODD. This is an oversimplification, but as a matter of principle this would be the case in the banking system, would it not?

Then my next question is, if there actually had been a $450 million withdrawal or transfer of funds from S. & L.'s to CD's, which also

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have a 4-percent reserve requirement, you could have an extension of roughly $11 billion in the money supply, 25 times multiplier, you see. And this could have a severe inflationary impact because you would make this much money available. Over the course of a year you could have a $44 billion expansion in your money supply by the banks if there was no leakage outside of the banking system. It would seem to me the action of the Federal Reserve would be self-defeating. They raised the interest rates as a tight money instrument, but because they are able to attract funds from the S. & L.'s to the banking system they actually expanded the money supply, if in this case it is 50 percent, it would be $22 billion expansion of the money supply. This expansion has an impact on the economy equivalent to a Federal deficit, so actually, their procedure instead of being deflationary was inflationary. Do you think there is substance to this argument?

Mr. HORNE. Certainly there can be, as I indicated yesterday, some very strong argument made on the side you have presented. And certainly, I do not think anyone can say there is not some substance to what you have said though there are some technical points to be cleared up.

Mr. TODD. Thank you. You would not want to estimate whether or not the high rate interest on CD's actually is inflationary or deflationary, would you?

Mr. HORNE. I think it could be, Congressman, depending on several factors, some of which you have indicated.

Mr. TODD. I would just like to suggest to the committee that we have a problem here of some magnitude and I think we should look at it in this context, and that is, perhaps the financial institutions are competing among themselves for money. They are establishing their policies in a competitive fashion with each other rather than working together in the establishment of policies. As a newcomer to this committee, it reminds me of Governor Robertson's phrase of competition in laxity, applied to the regulatory functions of the banking agencies, where they establish different rules for the banks under their jurisdiction. Do you think there is any of this competition existing between the financial agencies at the Federal level to secure funds one from the other?

Mr. HORNE. I think today, Congressman, there is competition, not only between banks and S. & L.'s and vice versa, mutual savings banks and S. & L.'s and vice versa, but also competition among the S. & L.'s themselves with one another and among the banks with one another.

Now, on the one hand, I realize as a person who believes in private enterprise, that it can be argued that this is good—based on the law of supply and demand—let the management decide for itself.

On the other hand, I must say I am concerned about a rate war, I am concerned about the possible adverse effects on the whole financial structure that an unlimited rate war can inflict on the economy as a whole. As much as I believe in private industry, I think the Government, when it is insuring deposit and savings accounts, and when it is trying to preserve the safety of people's funds, the safety of banks and other financial institutions, has to exercise certain functions.

Mr. TODD. Thank you very much. Thank you, Mr. Chairman.

Mr. REUSS. We will now have an opportunity for members to pursue questions on the second go around. Mr. Fino?

Mr. FINO. Thank you, Mr. Chairman.

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Mr. Horne, you have expressed great concern and great interest about the liquidity of our savings and loan banks. You have also expressed great fear that the issuance of CD's might hurt or further threaten the liquidity of our savings and loans. Yet you feel, from the testimony here today and yesterday, that the enactment of the Participation Sales Act will not have much effect on the liquidity of our savings and loan banks. Now, is it not logical to assume that all depositors or most of the depositors in the savings and loan banks will withdraw their money which pays about 4½ percent and buy participation certificates which will pay 5½ percent?

Mr. HORNE. Well, Congressman, for the reason that I gave a few moments ago, I am candid in saying that I do not share the fear in this area that I believe you feel.

One reason is that the size of purchases under the participation program is already limited and the Treasurer has indicated it will be even more limited.

Mr. FINO. Wait a minute, you are talking about the denominations.

Mr. HORNE. Yes, sir.

Mr. FINO. If the Congress, more particularly, the House will follow my suggestion on Monday, I will offer an amendment to cut down on the denominations so that the poor people, the little people, the small guy can participate in this financing.

Mr. HORNE. That gets back to a point that I think is quite similar in position to what the chairman expressed a few moments ago, and as I indicated at that time, my inclination is to be in sympathy with the small investor.

But on the other hand, I think there are times when the small investor can be hurt by other considerations. In addition, as far as the 5½-percent rate is concerned, I rather doubt that very many of the small investors—some of them no doubt would, if your amendment carries—would go into the participation program than would be the case if it is kept at 5,000 or even increased. There are other savings institutions, particularly banks with CD's that are paying a similar rate. So for a multiplicity of reasons, I do not anticipate that, so far as the $4.7 billion that goes across the entire spectrum, much outflow will result from any savings and loan associations per se. I could be wrong.

Mr. FINO. It is anticipated that there will be participation sales to the extent of $8 billion within 2 years.

Mr. HORNE. I believe that if the amount should be increased beyond the $4.7 billion figure congressional approval would have to be obtained. I think I am right on that.

Mr. FINO. I would assume yes. How much longer do you think the Treasury will be able to sell 4.5 percent Treasury bonds to the public that will have an opportunity to make 5.5 Treasury bank participations?

Mr. HORNE. I suppose the Treasury would be more of an authority on that than I could. I am not trying to evade your question.

Mr. FINO. Thinking of the little guy, the little fellow, who is on the savings bond program, having a certain amount deducted every week or every month from his paycheck in order to buy savings bonds, do you think that it is fair that he should be straddled—if he is patriotic—straddled at 4.15 percent on investment and the big investors, the big cats will be getting 5.5 percent?

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Mr. HORNE. As I said, Congressman, I think that there are certain circumstances under which this will not necessarily be an unreasonable situation.

Now, the man who is getting 4.15 for his bonds, he can turn them in if he wants to and already he can go to a savings and loan association or to a bank and get a higher return than the 4.15. I realize a lot of us, including myself and no doubt many, many other people buy the savings bonds because of patriotism. I just do not see myself, and I am admitting that I can be wrong, that under the program as it is presently constituted and presently being explained, that there is going to be any sizable outflow in this particular area from savings and loan associations. There has not been so far.

Mr. FINO. It is hard to follow your logic and reasoning because it is happening with the CD's. Everybody is getting excited because we have an opportunity to make more money on these.

Mr. HORNE. Well, there is a fundamental difference in practice. I know that within time the participation program, if Congress should approve it, would become more widely known. It would become more widely accepted. I think it is the great amount of advertising, just every day in newspapers, radio, television, and other sources that has resulted in so many people being rate conscious between one savings and loan association and another and between savings and loan associations and the ability to go to banks and to buy CD's.

That is another reason then that I believe that there will not be any great influx into the participation program from the savings you are now talking about because the saver just does not have the familiarity and understanding and acquaintanceship with it. Furthermore, the typical security buyer goes into this area.

Mr. FINO. You are telling us then that it is not the little guy but the fat cat that is going to benefit from all this interest rate rise?

Mr. REUSS. I would ask his question, Mr. Horne. I believe your proposed remedy for the disequilibrium we now have in banks and savings and loan associations, as a result of the certificates of deposit, is to make illegal or give the Federal Reserve power to make illegal, the smaller amount certificates of deposit so that those presumably would tend to stay in the savings and loan system, is that correct?

Mr. HORNE. Yes, sir.

Mr. REUSS. I have been concerned at the extra inducement to banks to issue negotiable certificates of deposit contained in the fact that they only have a 4-percent reserve requirement as opposed to the 16-percent reserve requirement generally for demand deposits.

Would it be useful either by itself or as a supplement to the amendment you suggest, to increase or direct the Federal Reserve to increase the reserve requirement of negotiable CD's? Would this not make them less irresistibly attractive to banks, since the banks would not want to pay as high an interest rate as they now are paying, and thus leave more of the money in the savings and loans?

Mr. HORNE. I was quite intrigued, Congressman, with that thought when you first suggested it I believe, several weeks ago. It does seem to me offhand, it would have all the effect that you anticipate it would have.

Mr. REUSS. Can you see anything wrong with that?

Mr. HORNE. From my understanding of it, no, I do not.

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Mr. OTTINGER. Will the gentleman yield?

Mr. REUSS. I will yield.

Mr. HANNA. I was asking you to yield on that point.

Mr. REUSS. I will yield to Mr. Hanna.

Mr. HANNA. I think if we bring into focus then the colloquy you just had with the gentleman and with his comments previously and then relate it to the bill, I would ask, is it not true, then, that insofar as this legislation is concerned that you would be much more readily in support of a bill which directed itself to both negotiable and non-negotiable CD's, No. 1?

Mr. HORNE. Yes, sir.

Mr. HANNA. That addressed itself to the size of those CD's and, No. 2, in that regard, would you not say that we would be on historically firm ground if we struck a $10,000 figure in recognition of the deposit situation and then if your answer is affirmative to that, would not No. 3 be the matter of the time of the CD's, because if we are concerned—this may not be your concern—but if we are concerned about the point you made which was the rollover requirement of these CD's, that the banks should not make these short term. They should not be 30 days because then that is when they have to be rolled over.

That brings us to the fourth point which Mr. Reuss makes, and that is, that the reserves behind these ought to be part of our consideration. So I think we have four points here, Mr. Chairman, that you have brought out in this hearing.

That is, that we need to consider both negotiable and nonnegotiable. We should consider the size, time, and finally, the reserves behind them. Is that a fair assessment of it, or do you think—where do you think the legislation on it reasonably ought to go?

Mr. HORNE. In my opinion there is. I say this with due regard and much sympathy with the point of view that has been expressed by the chairman of this committee and by Congressman Fino.

Also, I would say that what one saver or investor can or is willing to do may justify his getting more than someone who will do less.

I say it reluctantly, but I also say it candidly. I should also like to suggest that if this committee should come up with such legislation, that they include in it the time deposit open account, otherwise there would be a loophole that you would not intend to permit.

Mr. REUSS. I will yield also to Mr. Ottinger.

Mr. OTTINGER. I would like to express my agreement, Mr. Chairman, with your approach to requiring reserves behind these CD's that are somewhat comparable to demand deposits. They are comparable to deposit mansize.

I would like to ask the witness whether, if we put such a requirement for reserves he thinks it would be necessary, as Mr. Hanna points out, to require a time for maturity of these deposits and if so, what time he would recommend?

Mr. HORNE. Again, I am not trying to avoid answering your question. It seems to me it could be 6 months, it could be a year. Certainly, it is my opinion that 30 days is too short a time. Ninety days would be questionable. Six months or a year it seems to me would be more appropriate.

Mr. OTTINGER. If you have a reserve requirement is it necessary as well to have a time limitation?

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Mr. HORNE. The reserve would mitigate it to a degree but you may still want to impose other requirements; yes, sir.

Mr. OTTINGER. Thank you, Mr. Chairman.

Mr. REUSS. Mr. Gonzalez?

Mr. GONZALEZ. I have some questions that are not exactly in point here, but they are related. They have to do with information that I would like to obtain.

What is the picture with respect to the savings and loan movement? Is it growing or is it fairly static? Has it stabilized?

Mr. HORNE. Perhaps some figures, if I recall correctly, would answer your question, sir. At about 1947 the savings shares, savings accounts in savings and loan associations amounted to about $8 billion. Today these savings amount to about $110 or $111 billion. The growth has come most rapidly, and I should be very pleased to supply this committee with the year-by-year growth in any period of time you might want it. I just do not recall them offhand. The growth has come most rapidly in the 1950's and late 1950's and early 1960's and even in 1965 the net growth, if I recall correctly amounted to about $8.4 billion. It is true that so far in 1966, again, making a comparison between what the size of the industry is in January 1, 1966, and today, it is just about even. So for all practical purposes in 1966 it is not growing much.

We are hopeful and believe that later on this year, and particularly if there is some restraint in CD's—I want to point out again that CD's are not the only source competing funds as far as S. & L.'s or other thrift institutions are concerned—they will grow at a reasonable rate.

Mr. GONZALEZ. What about the number of institutions? Are new ones getting chartered? I mean on the Federal level?

Mr. HORNE. Here again I do not recall the exact figures, but generally speaking, the growth in the number of new institutions, both State and Federal I think has been quite moderate, quite conservative, and while we continue to get some applications we do not get an overwhelming number and we look very carefully at the ones we do get, both as to insured accounts of newly chartered State associations and as to chartering Federal associations.

Mr. GONZALEZ. Is it relatively easy or more difficult to charter a new organization?

Mr. HORNE. I would say it is more difficult today than it was a few years ago.

Mr. GONZALEZ. In other words, they are getting like banks. What about your advisory groups? I notice when I pick up a newspaper and find out that somebody from a district has been appointed to the Little Rock board or something—would you mind explaining the procedure there? Who picks these citizens? How do you arrive at who is going to be an adviser?

Mr. HORNE. I believe, Congressman, that you are referring to perhaps two areas. One has to do with the fact that each of the 12 banks has a board of directors. In each of these 12 banks, two-thirds of the board of directors are chosen by the savings and loan associations themselves and one-third, what we call public interest directors, are appointed by the Federal Home Loan Bank Board here in Washington.

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In making our choices we carefully try to choose people who are outstanding citizens, either in the business world or in the academic world or in the professional world and we carefully try to choose people who have no conflict of interests whatsoever with the savings and loan industry. Our system in this regard is a little bit different from that of the Federal Reserve Board. In the Federal Reserve Board of Directors in each of the 12 banks, about two-thirds are non-industry members. Whereas in our system about two-thirds are industry members. But this I believe answers your question in one area of advisory assistance.

Now, in addition to that, we have what is by statute, what we call a National Advisory Council. On this Council each of the 12 boards of the 12 banks select 1 member and then the Federal Home Loan Bank Board appoints 6 members. In addition to that, we get advice in every mail. Sometimes almost by the wheelbarrow loads from industry members themselves which we try to read and try to weigh carefully.

Then we constantly meet with members of the industry, either at the State level or at the district bank level and then in addition to that there are trade associations and the trade associations frequently request, and are always granted an opportunity to forward to the Board and to talk with the Board and advise the Board about problems within the industry.

So I think I could honestly say there is no operation in the Federal Government that gets more advice from more different sources than the Federal Home Loan Bank Board gets.

Mr. GONZALEZ. Thank you.

Mr. REUSS. I see our distinguished colleague, the gentleman from California, Mr. Holifield, is in the hearing room and knowing of his interest in monetary policy in general and savings and loan associations, we will welcome his sitting here with us and directing any questions he may have as a witness.

Mr. HOLIFIELD. No questions.

Mr. REUSS. Mr. Ottinger?

Mr. OTTINGER. I would like to insert in the record a lead article on the financial page of the New York Times, May 10, 1966, concerning the warning issued by Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs about the seriousness of the situation confronting the savings and loan industry by the use of these certificates of deposit.

Mr. REUSS. Without objection, it will be admitted.

(The article referred to follows:)

[From the New York Times, May 10, 1966]

DEMING CAUTIONS ON BID FOR FUNDS—AGGRESSIVE BANK BEHAVIOR IN FIGHT FOR TIME DEPOSITS ASSAILED BY U.S. AID—WARNING FLAG IS RAISED—SOME INSTITUTIONS ARE SEEN OVEREXTENDING AND TAKING ON EXCESSIVE RISKS

(By Edwin L. Dale, Jr.)

WASHINGTON, May 9.—Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs, warned today against "overly aggressive behavior on the part of some banks in competing for time deposits."

Mr. Deming raised the warning flag in a speech to the Society of American Business Writers in Minneapolis. The text was made available here.

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He said the aggressive bidding for time deposits "may tend to distort the impact of monetary policy, impairing the stability of particular institutions and even of some sectors of the economy."

It could also "induce some banks to overextend themselves and take on excessive risks" in their lending, he added.

Pointing out that the "increased cost of time deposits has placed many banks under pressure to seek higher yields and more loans," Mr. Deming continued:

"Even where loans are sound, banks may get burned in their bidding for time deposits. If funds can be bid away from other institutions by a particular bank, that same bank may find itself losing deposits at a later date to a still more aggressive institution.

POSSIBLE RESULT

"The result may be a bidding up of time rates—not because funds can be employed profitably, but because funds are needed to meet current demands or to replace funds that were bid away by other institutions. In tight financial markets even the liquidation of good assets can be painfully expensive," he said.

Mr. Deming also said that "other financial institutions may be more vulnerable than banks to a sudden loss of funds."

He warned banks paying high rates on time certificates of deposit running 9 months or more into the future that "interest rates on loans can go both ways, and the commitment to pay high rates for a long period may prove to be risky and unprofitable."

A "more cautious" lending policy by banks "will not only be in the public interest but in the interest of the individual banks in question," Mr. Deming said.

He cautioned also that "when financial market pressures diminish, then time deposit rates—particularly those on savings accounts—may prove to have some downside rigidity." It may be difficult, he said, "for individual institutions to lower rates unless they have some confidence that others are similarly motivated."

Mr. Deming's warning came a day after the Federal Reserve and the Federal Deposit Insurance Corporation announced a joint survey of the "rates and terms" that commerical banks are offering to pay on time and savings deposits, and on changes in the flow of savings funds.

The Federal Reserve made a similar study earlier in the year, which came to the conclusion that banks have made only "moderate" use of their present ability to pay up to 5½ percent interest on savings deposits.

In a wide-ranging speech the Under Secretary also touched on the outlook for Treasury debt management in the period ahead. He said, "We expect to get by with a minimum of cash borrowing over the next 14 months."

Allowing for increased sales of Federal assets through "participation" and for the regular sales of securities of Federal agencies other than the Treasury, and also allowing for offsetting absorption of some Treasury securities by the Federal Reserve System and Government investment accounts, Mr. Deming said the net demand of the Federal sector on the private credit market "should be under $3 million during the present fiscal year and approach zero during fiscal 1967."

Mr. OTTINGER. I would like to ask you a few questions on a slightly different tack, Mr. Chairman.

You recently issued a regulation to your banks which I understand restricts very much the advance commitments which they can make. I believe it was for 4-month repayments. Is that correct?

Mr. HORNE. You mean—I think you have reference to the April 20 letter in which we called attention through the bank presidents to the individual savings and loan associations that after—we try to help them take care of through the cash window, the commitments they have already made and the withdrawals they may experience, that they should go very carefully—should act very cautiously on future commitments.

Mr. OTTINGER. You suggest specific restrictions on forward commitments.

Mr. HORNE. Yes, sir.

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Mr. OTTINGER. Would you supply that for the record, please?

Mr. HORNE. Be glad to.

(The letter referred to follows:)

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., April 20, 1966.

To the Federal Home Loan Bank Presidents:

You are all well aware of conditions prevailing in the economy and the savings and credit markets. These conditions dictate policy responses by both the Federal Home Loan Bank System and all its member institutions. The objectives of the System obviously remain unchanged, and the capacity of the System to achieve those objectives remains unquestioned. Nevertheless the objectives do require changes in procedures as economic conditions change.

In the light of the current situation we call to your immediate attention, and request that you point out to your respective regional boards of directors, and to all your member institutions, the following major policy items:

1. Current policies governing withdrawal advances should remain unchanged.

2. Member institutions should carefully regulate and control their outstanding commitments, including undisbursed loan proceeds, to levels not exceeding the total of the previous calendar 4 months loan repayments plus or minus their realized savings gains or losses for the same past 4 months. Moreover, if the judgment of the board of directors of an individual member institution indicates a probable reduction in the coming period of loan repayments, or a reduction in savings inflow, such judgments should promptly be reflected in a working down of such outstanding commitments. For all future commitments executed from this date forward management cannot expect the advance window to be ever open if management itself has failed to gear its commitment level at its actual cash flows.

3. Expansion advances are not to be used as permanent additions to capital. Such advances are to be utilized only for seasonal needs and to cover commitment requirements that have been maintained at realistic levels but where unexpected, adverse, reduced cash flows have developed.

4. All loan officers of all regional banks are expected to examine each advance application in prudent detail. Previously established lines of credit certainly do not preclude such examination, nor acceptance, rejection or modification of the proposed loan application. This is especially true of expansion advances. Particular attention shall be given to the precise purposes of the proposed advance and the type of properties and transactions for which the funds are sought. Generally, such advances should not be employed to finance highly speculative ventures which would contribute to excesses in the housing inventory; to finance commercial, industrial or other residential property; or to refinance existing mortgages on all types of property in substantial volume.

The Board will institute a reporting procedure to test the conformance of expansion advances to the foregoing principles.

Sincerely,

JOHN E. HORNE, *Chairman.*

Mr. OTTINGER. Does that not further aggravate the situation with respect to the availability of mortgage money, because a great deal of further restraint on the building industry's ability to proceed, probably makes itself felt in the building market some 6 or 9 months hence?

Mr. HORNE. Congressman, unquestionably, this would serve to curtail the amount of money that could be obtained for homebuilding purposes through the 12 banks that compose the bank system. But I think also we would be acting unwisely if we attempted to meet through the windows of the 12 bank systems unlimited amount of money for homebuilding purposes.

We do have a problem here that goes further than just meeting new demands for homebuildings.

Mr. OTTINGER. There is a range between an unlimited amount of money made available to the building industry and the situation we

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have now where the savings and loan institutions in my area say that they cannot make any new commitments at all with the combination of restraints imposed on them by the shortage of funds caused by the deposits and your new regulation.

They say they are just out of business——

Mr. HORNE. I am just being perfectly candid in saying that I think we would be making a mistake for several reasons which perhaps you might want me to talk with you privately about, if we attempted to meet all the demands through the windows.

The 4 months' repayment is a normal level—Dr. Schwartz may want to speak more specifically on this.

Mr. OTTINGER. I do not say that this ought to be unlimited, but I wonder if the combination of these two things together, the complete shortage of funds through the draining that is taking place as a result of these certificates of deposit, and this regulation coming on top of that, if you were not just calling building to a halt all over the United States.

Mr. HORNE. We are weighing this and keeping in touch with it as much as we can. I am sure that you also recognize that there are other people going to the market for money, also, including the U.S. Treasury. Then, as I pointed out also——

Mr. OTTINGER. Why should the building industry take the total brunt of this? Why should not that be equitably distributed throughout the economy?

Mr. HORNE. I think it is; I think we are being treated fairly generously as to what we are allowed to go to the market for. Where the squeeze comes, the flow of savings is not going to the S. & L.'s themselves and this gets back to the CD problem which is one of the problems this committee is looking at and other sources that compete for funds.

Mr. OTTINGER. How long a period do you contemplate that this regulation would remain in effect?

Mr. HORNE. I think it will depend to some degree on how long this present tight money market continues. I think it would also depend to some degree on what the Treasury's needs have to be. I am sure everyone recognizes that all of us, to go to the market, have a coordinating mechanism that is used because if each of us went to the market separately and independently and willy-nilly, we can produce chaos.

Mr. OTTINGER. I would like to express my concern over the degree to which the building industry is required to bear the brunt for the tight money situation. I would like to see the Board reconsider the situation.

Perhaps we can alleviate it through the regulation of certificates of deposit. In the meantime, the building industry itself is asked to share the burdens of tight money to a greatly disproportionate degree and that you as the supervisor over the savings and loan institutions which supply the majority of the building money ought to be particularly concerned about this and not get walked over.

Mr. HORNE. I am in sympathy with what you are saying.

May I make a brief remark about it? I am sure you realize it is not our policy, the Federal Home Loan Bank Board, that has brought

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about the squeeze. We are in sympathy with the associations in the industry and we want to be as helpful as we can.

In trying to be helpful we also have to weigh the fact that there are other things that may have to take priorities over expansion of building. Then also, I think I should point out again as I pointed out yesterday, that individually, savings and loan associations are getting a quite substantial number of dollars through repayments and interest on loans outstanding. So it is not that they have no money at all. They have much less than they used to have, this is true.

Just because an association—this is another point that I would like to emphasize—an association does not have money to commit for the future does not reflect on its soundness. If an association does not have the money to commit far into the future, it can be just as sound as any of Uncle Sam's dollars. Erroneously, some people have thought that because some of the associations cannot make a commitment down the road they are in extreme financial difficulty as far as safety and security is concerned, and this is not the case at all. I know you did not ask me the question on this point, but I wanted to add this while I am answering.

Mr. OTTINGER. The nature of the building industry, though, requires that they have to be able to anticipate the mortgage money that is available and well in advance of the time the actual building takes place.

I have had two large associations in my area say they are finished as far as the future is concerned because of the tightness of the regulation.

Mr. HORNE. Unquestionably this is one of the difficulties that the homebuilding industry always has and that is, the peaks and valleys as to the availability of funds and this is one reason why Congress on many occasions to provide some help in this area has appropriated funds to FNMA.

Mr. OTTINGER. I would hope that you would take a look at this because I do not think that the building industry should be made to disproportionately bear the burdens of the tight money policy or the requirement of the Federal Government to go out for money on the market. I think it is going to be definitely aggravated by the Participation Sales Act we are embarking on. That is going to make the situation more difficult for the building industry.

Mr. HORNE. Let me say again——

Mr. OTTINGER. I do not see why we should be unreasonable about this. There should be some balance there and you are the logical person to protect your area against the opportunism of the Treasury Department and administration or whatever it may be.

Mr. HORNE. I want to say finally again, we do not have the unlimited power to make up this gap and I would not want to mislead the committee into thinking we do have it.

Mr. OTTINGER. I appreciate that and perhaps the real force of my comments is not directed against or toward you, Mr. Horne, but rather the people who are setting these policies. I do think a really serious situation in the balance has been created here. I would hope that you would do what you can to see that this is rectified.

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Mr. HORNE. I shall, because I spent a lot of my life doing things that I thought and I think would enable people to own their own homes. That is still my wish.

Dr. SCHWARTZ. Congressman, I think the Chairman covered the point rather well when he said the Board or he did not have the final authority in any of these issues. We are confronted by the money and capital market which has just become very, very tight. The Board's role in this is marginal. The Board does not control the flow of savings which has created the situation that has led many institutions to withdraw from the market—not just the savings and loan associations, but insurance companies and banks are moving away from the market, too. You have everybody moving away from the market simultaneously.

In past periods, when this has happened, the market has not been so tight that the Board could not step in and lend some assistance. But in this situation, it is so tight that combined with the change in the flow of savings, the impact on the Board for funds is such that there has to be some restriction on the lending though not complete restriction. I think the letter is being misinterpreted.

The basic point is that we are in a market economy and the market does impose constraints.

The other side of the coin—I think it was Mr. Harvey who raised the question about mortgage rates coming down. From 1961 to most of 1965 mortgage interest rates did come down, and actually builders were in a very favorable position as far as getting commitments were concerned. Savings and loan associations, commercial banks, insurance companies, and mutual savings banks were all flooded with liquid funds and there was not enough demand from other sectors to absorb it and the mortgage market was heavily favored.

Now, we have a reversal of this situation. I would like to be able to say that it is temporary, but I think it would be a little imprudent to go that far out on a limb.

Mr. OTTINGER. Thank you, Mr. Chairman.

Mr. REUSS. Mr. Annunzio?

Mr. ANNUNZIO. I yield to Mr. Rees.

Mr. REES. Just one question, Mr. Chairman.

We have a problem in California and I think in most States where savings and loan institutions are losing money. People are walking in, giving them the passbooks and say, "Please let me draw on my account," and they get five and a half percent. In about 3 or 4 weeks they are going to buy some of the Federal Home Loan Bank debenture notes to take care of withdrawals of institutions that are restricted to 4.85 percent.

If you issue this security you are going to have to issue a lot of them to shore up all the savings and loans throughout the Nation so that they could meet their withdrawals if they are limited to 4.85. You are going to have to go out in the open market and compete for that money.

Would it not be a lot easier to allow the savings and loan institutions to do some competition of their own to allow them a higher interest rate? Would it not be easier to tell the institutions, you can go to 5½ percent if you want? Then the FHLB will not have to go

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out in the open market and sell securities. Our national debt does not go up by that amount and then you are not competing against other types of Government securities which seem to be in the market today.

Would it be a lot easier to allow a kind of restrictive free market where a lot of savings and loans go up to 5½ percent just as the banks are doing in terms of CD's? There would be less pressure on you and you would reverse the withdrawal trend. Not only would they not be going to you for more money, but they would find that they would have more money in terms of savings coming in and therefore they would be able to save some money on the mortgages. Do you not think it would be a lot easier this way than going through all this rigamarole issuing new Government paper?

Mr. HORNE. Let me make, if I may, sir, very respectfully, three or four comments to your very good question.

No. 1—this is repetitious—if you compare the savings deposits in California associations at the end of April with what they were around the beginning of January, there is a $24 million decline.

No. 2, what the Board did early in the year to enable them to meet the competition that the increase by banks, particularly when the Bank of America went to 5 percent, was based primarily on what many of the California associations at that time recommended. They were not in agreement as to what they thought the Board should do, as to what kind of defensive mechanism they thought the Board should grant.

No. 3, since we took that move and with further exploration down the line we are now on the verge of providing more leeway than they presently enjoy.

I want to reiterate that we have to bear in mind that we must take a responsible position. Looking at the industry as a whole, that when we allow for differences among areas we have to keep in mind what adverse effect it might possibly have—not only on some other California associations, but across the country as a whole. I am sure that Congressman Weltner's comments did not escape your observations a few moments ago, and I might say in complete honesty, that we have worlds and worlds of criticism heaped on the Board of what is permitted in California as compared to other parts of the country. And also because of the fact that most of the money that comes from advances, throughout the system, goes to California associations.

Then, my final point, there is not a California association today that cannot do exactly what you have suggested, provided that he understands that in doing so he could not go to the cash window and get money for expansion purposes. He can still get money to meet withdrawals. He simply would not be able to get his money to go out and build new homes and add to what he is getting by paying whatever rate he chooses.

I might also say this is connected with what another Congressman—I have forgotten who it was—said that we were being criticized because we opened the door too much and had led to surplus building in parts of the country by having done so.

I might say that to some degree the Board can in certain places be justifiably criticized in this regard.

Mr. HANNA. Would the gentleman yield for a moment? I think that the Chairman answered very honestly in terms of this problem,

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but I should like to put in the record at this point to make your answer more, I think true, of the situation—the answer to this question:

How much money was asked in advances to meet withdrawals in the first quarter?

Mr. HORNE. Dr. Schwartz will give you the answer to that.

Dr. SCHWARTZ. For the month of April, I will answer that where we have solid figures and where my memory is better.

Mr. HANNA. Does $500 million appear to be it?

Dr. SCHWARTZ. From March 28 through the other day we have put out about $900-some-odd million. Some of that is expansion money to take care of commitments that were on the books.

Mr. HANNA. A large portion is withdrawals?

Dr. SCHWARTZ. A large portion is withdrawals.

I would say two-thirds to 75 percent of that is withdrawals. We do not ask the banks to give us a purpose analysis of the advances. But we do get some indication from them when we have this size withdrawal and we ask them just to give a rough summary and this is what the summary indicates.

For the year as a whole, advances are up sharply. I would say they are up considerably more than they were last year at this time, and this is due to the fact that the savings inflow in the first quarter, particularly outside of California was unfavorable. In fact in January and February, the California associations, particularly in January, the California associations looked pretty good against the rest of the country.

Mr. HANNA. As an average?

Dr. SCHWARTZ. Altogether, and I think individually with some few rare exceptions.

Mr. HANNA. Would you provide for the record the actual withdrawals. the advances from withdrawals in the State of California?

Dr. SCHWARTZ. We would have to get a special analysis on that.

Mr. HANNA. I want to find where it really is here. If you figure on the average it is like talking about a pool that has a 10-foot depth, but if you talk about the average you figure there is safety, sure, because nobody is going to drown in 6 inches of water.

Dr. SCHWARTZ. Until March 28 I do not think there was a withdrawal problem in California.

Mr. HANNA. These are figures we need to have along with the averages.

Dr. SCHWARTZ. We will supply the information you request.

(The information requested follows:)

Advances made by purposes, Federal Home Loan Bank of San Francisco

Month	Withdrawals	Other purposes	Total
January	$33, 352, 600	$61, 323, 000	$94, 675, 600
February	6, 087, 528	54, 787, 357	60, 874, 885
March	10, 105, 000	106, 992, 000	117, 097, 000
April	470, 024, 200	101, 718, 000	571, 742, 200
Total	519, 569, 328	324, 820, 357	844, 389, 685
Percent of total	61. 5	38. 5	100. 0

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Mr. Reuss. If there are no further questions we want to thank our witnesses for their patience for being with us 2 days.

We will not stand in adjournment until the call of the Chair.

It is anticipated there will be heard witnesses from the Treasury, the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, National Association of Home Builders, and the American Bankers Association.

We will now stand adjourned.

(Whereupon, at 12:10 p.m., the committee adjourned, to reconvene subject to the call of the Chair.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, MAY 19, 1966

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Multer, Mrs. Sullivan, Ashley, Moorhead, St Germain, Gonzalez, Minish, Weltner, Grabowski, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Widnall, Mrs. Dwyer, Halpern, Harvey, Brock, Clawson, Johnson, Stanton, and Mize.

The CHAIRMAN. The committee will please come to order.

Today the committee is privileged to hear the Secretary of the Treasury, Hon. Henry H. Fowler, testify on H.R. 14026 and other measures to control the use of certificates of deposit.

As the chief financial officer of the executive branch of the Government, Secretary Fowler has a special responsibility for assessing new financial developments such as the negotiable certificate of deposit. This is particularly the case where there are strong reasons to conclude that the negotiable CD is adversely affecting the Treasury bill market, making more costly to the taxpayers the carrying charges on the national debt. Economical debt management is, of course, a primary responsibility of the Treasury Department. Only recently, the administration was forced to seek an unexpected appropriation of three-quarters of a billion dollars just to meet extra interest costs for fiscal 1967 over 1966. Interest rates on both long-term and short-term Treasury obligations are at near-record highs.

We have a graph prepared on the basis of information furnished by Treasury which indicates a definite relationship between the ceiling that member banks may pay on time deposits—including the negotiable CD—and the Treasury bill rate. Perhaps the Secretary will also elaborate upon a memorandum furnished the chairman by Treasury staff last February which only indirectly answers the question of the influence of CD's on Treasury bill rates. In this connection, it should be noted, according to a recent Securities and Exchange Commission report as well as from many, many unofficial sources, that there has been a substantial shift of corporate cash out of the Treasury bill market and into the negotiable CD market in New York—over $2 billion just last year.

We would also appreciate a progress report on the joint Treasury-Federal Reserve study of the U.S. Government securities market. I

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understand that one of the main purposes of this study is to investigate the competitive impact of CD's on Treasury securities.

We are aware that very recently the interest rate on Treasury "E" bonds was increased to 4.15 percent. While deploring the rise in the cost of debt management, we are glad to know that the Department has taken steps to reduce differences in rates between marketable and nonmarketable Treasury bonds which discriminate against the small saver.

We are also interested in a report from the Secretary of the Treasury on the accomplishments of the Coordinating Committee on Bank Regulation, for which Mr. Fowler is responsible to the President—the members being Chairman Martin of the Federal Reserve Board, Chairman Horne of the Federal Home Loan Bank Board, Chairman Randall of the Federal Deposit Insurance Corporation, and Comptroller of the Currency Saxon. The purpose of the Coordinating Committee is to avoid serious disagreements among the various financial supervisory agencies. As regulation Q is essentially a bank supervisory instrument, we would appreciate hearing what the role, if any, the Coordinating Committee played in the amendment raising regulation Q last December 6.

(The following material was submitted by the Treasury Department:)

THE INFLUENCE OF NEGOTIABLE CERTIFICATES OF DEPOSIT ON TREASURY BILL RATES

As Chairman Patman has indicated, the Treasury staff memorandum prepared on an earlier occasion for the House Banking and Currency Committee did not reach definite, quantitative conclusions as to the effect on Treasury borrowing costs of the rapid development in recent years of the negotiable certificate of deposit.

The Treasury agrees that Chairman Patman's question is an important one, but it is also a very difficult one to answer in precise terms. For that reason, the staff memorandum was largely limited in its scope to a review of the historical development of the negotiable certificate of deposit as a money-market instrument. Further study of this and other influences on Treasury borrowing costs is continuing, although it is doubtful that the exact influence of the negotiable certificate of deposit can ever be isolated with great accuracy.

There would appear to be reason to believe that the rapid growth of the negotiable certificate of deposit may have exerted some upward pressure on short-term Treasury bill rates during much of the current expansion. In the absence of the development of the negotiable certificate of deposit, corporate and other funds temporarily in excess of current requirements would probably have been directed in larger amounts into short-term Treasury obligations, as well as other money-market instruments. This in turn, might have contributed to some easing of short-term Treasury rates in the absence of offsetting monetary or debt management action. In addition, more U.S. funds would probably have flowed into the Euro-dollar market which received much of its initial impetus from the relatively low time deposit rates payable in this country. Indeed, in view of the U.S. balance-of-payments situation, short-term interest rates—on Treasury bills and competing market instruments—have probably been no higher during most of the current expansion than would have been required in any event.

Domestically the negotiable CD has assisted commercial banks in competing very successfully with other financial institutions for short-term funds and has enabled banks to direct a large part of these funds into longer term uses. In the absence of such an inflow of funds, banks quite possibly would have been larger net sellers of Government securities and purchased fewer State and local securities. The net effect could have been higher long-term interest rates at an earlier stage of the current expansion.

This is not to say that very intense rate competition among the commercial banks that issue negotiable certificates of deposit would necessarily lead to desirable results. Recent experience—particularly since about the middle of

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1965—suggests that overly aggressive competition for a limited pool of short-term funds can carry rates sharply higher. This not only tends to pull up Treasury short-term borrowing costs; it may also narrow or erase the margin that banks have made use of in borowing short and lending long, thus removing the influence of CD growth as a factor tending to hold down long rates, and possibly contributing instead to an upward influence on long rates.

PROGRESS REPORT ON THE JOINT TREASURY-FEDERAL RESERVE STUDY OF THE U.S. GOVERNMENT SECURITIES MARKET

This study was launched on March 1, 1966, with the broad purpose of ascertaining how the dealer market for U.S. Government securities has evolved and performed in the 1960's in light of economic developments during this period. Part of this picture involved certain innovations affecting the financial processes. They would include certificates of deposit and the greatly enlarged Federal funds market.

The joint study is being carried out by staff analyses, several of which are underway and are expected to be in first draft by midsummer; through questionnaires to U.S. Government security dealers, which have been distributed; through questionnaires to various investors in the market, which are being prepared; and through conferences with active market participants which are to be scheduled around midyear.

The steering committee for this study will draft a report analyzing this material when it bcomes available.

ACCOMPLISHMENTS OF THE COORDINATING COMMITTEE

MAY 25, 1966.

The Coordinating Committee, composed of the Comptroller of the Currency and the Chairman of the FDIC, FHLBB, and Federal Reserve System, has provided a valuable forum for discussion of supervisory problems and other matters affecting financial institutions. Meetings have been held at approximately monthly intervals since the group was established last July. Formation of the Committee followed through on the suggestions made by President Kennedy's Committee on Financial Institutions in April 1963 and President Johnson's suggestion in March 1964 for additional exchanges of information among bank regulatory agencies.

While the Coordinating Committee did not play a role in the decision to change Federal Reserve's regulation Q last December—this was the decision of the Board of Governors of the Federal Reserve System—several meetings of the Committee have been held since the December change in regulation Q in order to appraise the effects of that change on the competition for savings and to discuss further actions that might be desirable in light of those developments.

The CHAIRMAN. Mr. Secretary, we are very pleased to have you as our witness today and you may proceed in your own way.

Do you have a prepared statement?

Secretary FOWLER. I do, Mr. Chairman.

STATEMENT OF HON. HENRY H. FOWLER, SECRETARY OF THE TREASURY; ACCOMPANIED BY PETER STERNLIGHT, DEPUTY UNDER SECRETARY FOR MONETARY AFFAIRS; AND FRED B. SMITH, GENERAL COUNSEL

Secretary FOWLER. Mr. Chairman, in my prepared statement I have addressed myself rather narrowly to the bills before this committee which in different ways would affect the acceptance or issuance of time deposits by insured commercial banks. I will not cover in my prepared statement today other matters which are of a broader nature or which you solicited some comment in your opening statement.

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However, I would like to have the opportunity to address myself to them for the record.

The CHAIRMAN. You may do that. We hope all the questions will be answered for the record.

Secretary FOWLER. They will, for the record, and promptly, Mr. Chairman.

(Material submitted in response to the questions raised by Chairman Patman in his opening remarks will be found on pp. 130–131.)

The CHAIRMAN. I hope you deal with the illegality of negotiable CD's. Are you dealing with that in your statement?

Secretary FOWLER. Yes; I think my comments will embrace that subject, although not in a technical way.

Mr. Chairman and members of the committee, I have been asked to comment today on two bills before your committee—H.R. 14026 and H.R. 14422—which in different ways would affect the acceptance or issuance of time deposits by insured commercial banks. Before addressing myself to these two bills and making certain specific suggestions of my own, I would like to offer a general comment on recent developments regarding the competition for time deposits.

I should point out, first of all, that the Treasury does not have a direct supervisory interest regarding the rates and other terms offered on bank time deposits and on competing investment forms offered by other financial institutions. However, because of our general concern about the state of the economy, and our particular concern with the management of Government finances, we have a continuing interest in the maintenance of stable financial markets. Moreover, in bringing together, as your opening statement made reference to, at the request of the President, a Coordinating Committee on Bank Supervision—which includes the Comptroller of the Currency and the Chairmen of the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Federal Reserve Board—the Treasury has been actively interested in this question.

Recent developments in the competition for savings may be traced conveniently back to 1961, when a combination of more aggressive competitive behavior by commercial banks and a series of revisions in the Federal Reserve's regulation Q and the FDIC's regulation 329 resulted in a substantial increase in commercial bank time deposits and in important changes in the portfolio policies of banks. Between yearend 1961 and yearend 1965 commercial bank time deposits increased by about $64 billion—or more than 75 percent. This is a compounded growth rate of 15.5 percent yearly—achieved on a base that was already substantial.

A portion of the accelerated growth in bank time deposits came from funds that might otherwise have gone to savings and loan associations and mutual savings banks; in some instances, this may have reflected a return flow of funds that had previously been shifted away from banks—for savings and loan associations, in particular, had enjoyed an extraordinarily rapid growth rate in the earlier postwar years. Some of the growth in commercial bank time deposits reflected shifts by corporations and public treasurers away from competing money market instruments including Treasury bills. And some of the increase in time deposits probably reflected shifts from bank demand deposits.

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More recently many banks have offered so-called savings certificates or "savings bonds," generally in nonnegotiable form, which have made higher time deposit rates available to individual savers with accounts largely in the $2,500 to $100,000 range. In some cases, the higher rates have been made available on savings instruments ranging even smaller in size—all the way down to about $20 or even less. In contrast, negotiable certificates of deposit—or CD's—are typically issued and traded in size units of $100,000 or more, serving as a liquid money market instrument rather than as a savings medium.

The rapid inflow of funds into banks spurred more aggressive lending policies by banks and encouraged many banks to move into areas of lending that had received less attention earlier. Mortgage lending, consumer credit lending, and investments in obligations of State and local governments showed particular increases among bank assets. On the whole, these shifts in bank lending and investing practices have been desirable, contributing importantly to the unprecedented growth of credit and economic activity that we have experienced in recent years. Banking has certainly become more competitive. The margins between what banks pay for funds and what they earn on loans and investments has narrowed and the public has benefited.

It is true that a few banks have used certificates of deposit unwisely to finance unsound loan portfolios. But such practices are not inherent to CD's or increased time deposit competition. Bank failures during the past few years have alerted supervisory agencies to potential problems and alerted the general public to potential risks.

As market interest rates have advanced during the past year banks have been under pressure to raise rates paid on time deposits, particularly in order to attract and retain rate-sensitive funds. The Board of Governors of the Federal Reserve System decided last December to raise the rate ceiling on time deposits from 4½ percent to 5½ percent, enabling banks to compete at higher levels. At the same time, the Board elected to keep the 4-percent ceiling on savings deposits, in order to limit the impact of rate competition among banks and between banks and other financial institutions.

In recent years many economists have favored eliminating, or placing on a standby basis, any interest rate ceiling on time and savings deposits. Both the Commission on Money and Credit, in 1961, and President Kennedy's Committee on Financial Institutions, in 1963, recommended placing on a standby basis interest rate ceilings that would apply both to banks and other thrift institutions. This recognizes that, in principle, it is hard to defend a policy that insulates banks and other financial institutions from competing among themselves.

While acknowledging this point of principle, I believe the present period demonstrates that there is a need at times for the guidance that regulatory agencies can provide. I might say parenthetically that, of course, was the inference in the report of the President's Committee on Financial Institutions in recommending that this authority be placed on a standby basis, because there was recognition at particular times that authority might be useful and desirable.

At the very least, ceilings are needed in transitional periods, when financial institutions are making adjustments to a changing competitive environment. Moreover, it is important that the authority of the

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supervisory agencies with respect to ceiling rates and other pertinent factors relating to time and savings deposits be available with some flexibility to distinguish among different types of deposits. Regardless of what ceiling rates or other conditions may currently exist or be proposed, the present experience should stimulate some hard thinking by all of us—in the financial markets as well as in Government—about the pros and cons of bidding for "hot money."

In seeking legislation in this area, I believe an important principle to keep in mind is the undesirability of taking an approach that would permanently inhibit healthy competition among financial institutions. It would be equally undesirable, however, to remain aloof to the point that destructive competition dealt permanent injury to our financial institutions and the sectors of our population and our economy that depend on those institutions.

One of the bills before you, H.R. 14026, would prohibit banks from issuing negotiable deposits or notes. This would substantially lessen the attractiveness to investors of large denomination certificates of deposit, although it probably would not eliminate their use entirely.

The possible effects of a sharp reduction in the volume of certificates of deposit are difficult to contemplate. Based on the funds they have obtained in this manner, banks have built up enormous additions to their assets—representing useful credits to many segments of the economy. It is not easy to say "where the money would go" if negotiable certificates of deposit could not be renewed as they matured. At the least, there would very likely be severe transition problems for particular institutions and segments of borrowers that found credit flows cut off.

To some extent, banks probably could continue to obtain funds by issuing nonnegotiable certificates of deposit, but this might require higher interest rates than are paid now. Almost certainly, banks would have to issue such certificates in shorter maturities than is the current practice, thus foreshortening the time when periodic renewals must be arranged.

H.R. 14026 would also prohibit banks from selling negotiable debentures. During the past few years banks have added more than $1.5 billion to their capital through the sale of debentures. If banks were able to sell debentures only in nonnegotiable form they would probably have to pay higher interest rates, if indeed they could sell them at all.

While I would not favor H.R. 14026, I do not mean to say that we see no problems at all in the CD area, or that we have no concern about the current role CD's seem to be playing in the interest rate structure. As beneficial as CD's have been over the past several years, I must say that aggressive bank competition to obtain these short-term funds—which has been the counterpart of the aggressive bank competition to extend credit in channels that benefited the economy—has worked at times to move short-term interest rates higher. When this process succeeded in generating a larger pool of funds than the banks could use in extending longer term credits, this additional pressure at the short end was tolerable. Indeed it was welcome in the early years of the 1960's in order to raise our short-term interest rates in relation to those rates abroad, thereby averting or retarding outflows that would add to the deficits in our balance of payments. But when we reach

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a situation where, to a considerable extent, banks are bidding against one another, or against others who must use the short-term money market, to secure more of a rather limited total supply of available funds, a question may be raised as to whether this useful device is perhaps being pushed too far.

As I said in a speech in Phoenix, in early April:

> I would hope, also, that there will be an accompanying disengagement from unreasoning competition for time and savings deposits that ignores the need for caution and the harm that kind of competition can do to our banking and financial system.

This is a question that has been under study within the Government, particularly in the last 5 months. We do not have simple answers to offer here. I cannot conclude that a flat ban on negotiable certificates of deposit would be desirable. If, in the judgment of the committee, some action is deemed desirable, a better approach might lie in the direction of providing the appropriate monetary authorities with greater discretion to set levels of reserve requirements on large negotiable certificates of deposit that might exceed those on other time and savings deposits. Of course, you will want to consider carefully the views of those much closer to the problem of day-to-day bank supervision on this matter.

Another bill before you—H.R. 14422—would prohibit insured banks from accepting time deposits in an amount less than $15,000. This bill, along with the present regulation Q ceilings, would in effect restrict banks to the 4-percent ceilings on savings deposits for accounts of less than $15,000.

While I have considerable sympathy with the apparent objectives of H.R. 14422, it does seem to me that its approach is unnecessarily rigid, and that it is unnecessarily discriminatory against smaller savers at commercial banks under the present interest rate spread.

At the same time, many of us are concerned about the considerable evidence that something should be done promptly to retard the outflow and threatened outflow of savings funds from savings and loan associations and mutual savings banks.

While none of us is in a position to evaluate just how serious this threat may be as a long-term matter affecting these institutions, there is a genuine current concern in the Congress, in the Federal Home Loan Bank Board, and in the private economy, that a continued savings outflow could place undue stress on some of these financial institutions, and undue constraints on the flow of money into the mortgage market and homebuilding.

Under the circumstances, the prudent course would seem to be to provide some simple form of insurance that could be put in effect speedily, that would tend to avoid drastic dislocations, and that would provide our savings institutions with an opportunity to make an orderly adjustment to new competitive situations. By placing a temporary restraint on excessive competition in this area, it should be possible both to protect the structure of the thrift institutions and to bolster the flow of funds to the homebuilding industry.

In acting promptly to provide temporary relief from the problems of excessive rate competition, I do not believe we should commit ourselves to permanent arrangements that would impede and compart-

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mentalize our financial markets. Rather the present purpose is to find agreement, along simple lines, on means for dealing with this temporary transitional problem.

With this background in mind, I would like to make certain affirmative proposals that I would urge this committee to consider and act on promptly. Specifically, I believe it would be desirable to provide the monetary authorities, on a temporary basis designed to cover this transition period, with discretion to set a different rate ceiling on time deposits up to the maximum amount covered by Federal deposit insurance. Under present circumstances, this would mean that a maximum rate of, say, 5 percent could—and I might say should—be set on time deposits up to $10,000. For larger time deposits, the first $10,000 would be covered by a maximum rate which could be set at 5 percent, while the balance could pay interest at rates up to those now specified in the Federal Reserve's regulation Q.

The choice of an appropriate size limit on which to set different maximum rate levels is not an easy question to resolve in view of all the equity considerations and competitive factors involved. We suggest $10,000 as an appropriate limit for two important reasons:

First, tying this limit to the maximum insurance limit makes sense in view of the Government's contingent liabilities on deposits up to this size. Assuming the necessity for establishing a limit, and I believe there is such a necessity, it is logical that those who have the protection of Government insurance should be prepared to receive a slightly lower rate on the insured amounts.

Second, based on our information about the current situation, we believe that this limit represents a middle course which should alleviate the impact of destructive competition for savings, without seriously impairing the ability of banks to engage in constructive intermediation. A limit of this nature, with the rate set in current circumstances at a 5-percent level, should be of significant help in deterring further large drains of funds from the specialized savings institutions. Timely protective measures, undertaken now, will help in relieving the liquidity strain on these institutions, and in turn relieving the strain on important sectors of the economy that depend on an availability of funds from these institutions—notably the mortgage market and the homebuilding industry.

Taken overall, I believe that the $10,000 dividing point, tied to the present insurance limit, makes sense from the standpoint of prudent economic policy. A higher limit—with discretion for setting the figure given to the appropriate supervisory authorities, but perhaps somewhere in the range of $25,000 to $100,000—might also make good economic sense in present circumstances. I would not be opposed to such a limit, provided on a temporary basis, and this is a point that the Congress should consider carefully, but my own preference in this temporary authority would be for a link to the maximum insured account size. Against the background of current policies as reflected in the recent announcement of the Federal Home Loan Bank Board on Tuesday, I believe this approach could be part of a framework for sustainable competition among thrift institutions.

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For the foregoing reasons, I sincerely urge the committee to give serious consideration to this proposal as an alternative to other legislative proposals before it. I have available copies of a draft of a bill which would provide temporary authority for a 2-year period to the Federal Reserve Board and the Federal Deposit Insurance Corporation to institute different rate ceilings for that portion of time deposits up to the maximum amount that may be covered by Government insurance.

Finally, I would like to emphasize just as firmly as I can that these proposals are not a cure-all or a permanent attempt to deal with the problem of competition in the financial area. Certainly, they are not intended to permanently impair competition—which is the vital force of our economy. Rather, they would provide a measure of insurance during a period of transition.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, I notice on page 2 you said these negotiable certificates of deposit went back to 1961. Are you not mistaken, did not CD's commence in 1960?

Secretary FOWLER. Well, the larger sizes emerged in 1961. I think they did appear earlier in smaller proportions.

I accept your statement. My impression was that the really rapid growth caught on in 1961.

The CHAIRMAN. I will place in the record at this point the history of them from 1960 down through 1965.

(The history referred to follows:)

Outstanding negotiable certificates of deposit in denominations of $100,000 or greater issued by weekly reporting member banks

[In millions of dollars]

	New York City	Chicago district	San Francisco district	Cleveland district	Dallas district	All other	Total
Dec. 31, 1960	5	21	219	41	247	263	796
Dec. 30, 1961	935	318	420	238	318	553	2,782
Dec. 5, 1962	1,650	794	598	480	486	1,434	5,442
Dec. 31, 1963	3,434	1,234	851	860	796	2,402	9,579
1964							
Apr. 1	3,707	1,331	1,081	905	903	2,705	10,632
July 1	4,006	1,464	1,250	866	921	3,158	11,665
Sept. 30	4,273	1,464	1,273	820	923	3,196	11,949
Dec. 30	4,556	1,672	1,328	906	944	3,177	12,583
1965							
Mar. 31	5,355	1,738	1,418	1,055	974	3,422	13,962
June 30	6,438	1,703	1,521	1,136	1,010	3,468	15,276
Sept. 29	6,680	1,772	1,483	1,167	1,061	3,751	15,914
Dec. 29	6,865	1,915	1,617	1,255	974	3,471	16,097
1966							
Apr. 20	7,352	2,149	1,937	1,306	1,085	3,549	17,378

Source: Office of Debt Analysis, Jan. 25, 1966.

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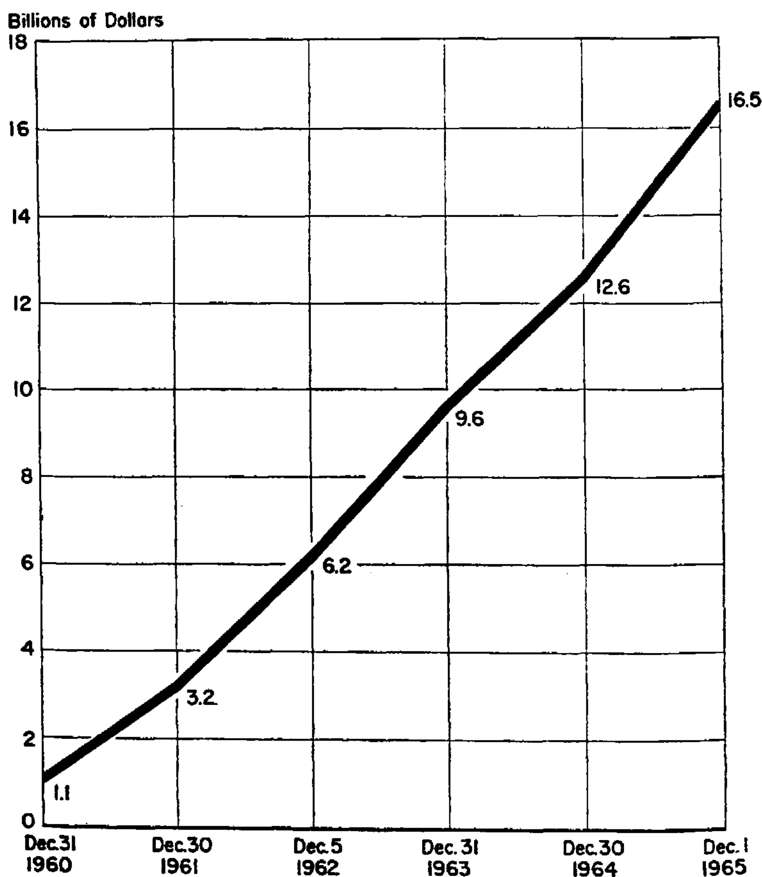
OUTSTANDING NEGOTIABLE TIME CERTIFICATES OF DEPOSIT, ANNUALLY, 1960-1965



Source: Basic data from Federal Reserve Board

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Maximum interest rates payable on time and savings deposits

[Percent per annum]

Type of deposit	Effective date							
	Nov. 1, 1933	Feb. 1, 1935	Jan. 1, 1936	Jan. 1, 1957	Jan. 1, 1962	July 17, 1963	Nov. 24, 1964	Dec. 6, 1965
Savings deposits held for:								
1 year or more	3	2½	2½	3	4	4	4	4
Less than 1 year	3	2½	2½	3	3½	3½	4	4
Other time deposits payable in: [1]								
1 year or more	3	2½	2½	3	4	4	4½	5½
6 months to 1 year	3	2½	2½	3	3½	4	4½	5½
90 days to 6 months	3	2½	2	2½	2½	4	4½	5½
Less than 90 days	3	2½	1	1	1	1	4	5½

[1] For exceptions with respect to foreign time deposits, see "Annual Reports" for 1962, p. 129, and 1965, p. 233.

NOTE.—Maximum rates that may be paid by member banks as established by the Board of Governors under provisions of regulation Q. Under this regulation the rate payable by a member bank may not in any event exceed the maximum rate payable by State banks or trust companies on like deposits under the laws of the State in which the member bank is located. Effective Feb. 1, 1936, maximum rates that may be paid by insured nonmember commercial banks, as established by the FDIC, have been the same as those in effect for member banks.

Savings by individuals in the United States [1]—1963–65

[Billions of dollars]

Type of saving	1963	1964	1965
1. Currency and demand deposits	6.8	7.0	8.8
2. Time and saving deposits	11.6	12.3	15.2
3. Savings shares [2]	11.7	11.3	9.2

[1] Securities and Exchange Commission Statistical Series Release 2118, Apr. 15, 1966.
[2] Includes shares in savings and loan associations and shares and deposits in credit unions.

NOTE.—The SEC also reported that during 1965 cash and deposits of all U.S. corporations rose $2,100,000,000, but that there was an equivalent drop in their holdings of U.S. Government securities. On July 17, 1963, the Federal Reserve Board reduced the minimum maturity on CD's bearing the highest rate permissible under regulation Q from 1 year to just 90 days.

The CHAIRMAN. The point that troubles me on this matter is the fact that your approach is not vigorous enough and rather timid and weak. This is my personal opinion. I was hoping that you would realize that this CD market has grown up here in the last few years—negotiable CD's only since 1960; 75—90 years ago the Congress passed a law that no national banking association—no national bank shall issue post notes or any other notes to be circulated.

Of course, that was done then because banks were issuing their own money. A bank would go broke and everybody would have this money but there would be nobody to redeem it. So the law was justified.

It occurs to me that we are permitting exactly the same thing in a different way today. In other words, we are permitting the issuance of interest-bearing circulating notes. Whenever you issue a CD, that can be sold at any time, and the money obtained on it, is that not very much like a circulating note, Mr. Secretary?

Secretary FOWLER. There are some similarities, Mr. Chairman.

The CHAIRMAN. If you had the responsibility in view of this statute, would you permit CDs' to be issued?

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Secretary FOWLER. I would not give a quick or an unqualified answer to that question. Since I do not have the responsibility, I have not studied it in depth on the legal question that you raise. I have indicated in my statement that I think this is something that exists, it is part of our system today. You may characterize the absence of a drastic approach as timid. I would characterize a drastic approach as being unwise.

The CHAIRMAN. Well, I notice you state here that the Federal Reserve Board and the Federal Deposit Insurance Corporation should be given authority to do these things. I think, Mr. Fowler, in dealing with the Federal Reserve you are going to have to make it mandatory.

Secretary FOWLER. Mr. Chairman, it is implicit in my statement, and in the proposal for this grant of authority in this kind of situation, that the legislation history of such a proposal would certainly, and should, include a clear intention on the part of the Congress and the regulatory authorities that, given the statutory authority, they would impose the 5-percent limit.

The CHAIRMAN. I think they would do it.

Secretary FOWLER. I would hope that in the process of exchanges that might occur some understanding could be arrived at.

The CHAIRMAN. We have been hoping with them for a long time, Mr. Fowler. During that time in piling more and more Government bonds they buy and pay for them with Federal Reserve notes; they now have over $40 billion in the New York Federal Reserve Bank. I believe that this is absolutely ridiculous. It is a reflection on Congress. It is a reflection on anybody who represents the people, that we have $40 billion up there. And they claim they can use that money for any purpose they want to. As evidence of the fact they pay dues to the American Bankers' Association, nearly $100,000 a year. It is scandalous and shameful that they use Government money for that. They insist on using that money for any purpose they want. Therefore, if they ever got into a political campaign they would have a $40 billion campaign fund to start with and no one could stop them because they do not come to the Government for funds to operate. They have gotten out from under the General Acconnting Office, they are not audited and they are going so far that I think it is time for the Treasury to take some stand on this.

Of course, possibly, not having the responsibility, I would want you to look over it very carefully, but I think all the facts in this situation should receive the attention of the Treasury Department.

You take in 1960, these huge corporate funds that now make up most of the negotiable CD market aggregating about $17 billion were practically all in the weekly Treasury bill auction market, Mr. Fowler.

Secretary FOWLER. As my statement indicated, the funds accumulated in this fashion came from various sources. Some of them were certainly in the bill market. Some of them would have been funds that would have ultimately flowed into other thrift institutions. Some of them are funds that are reclaimed in a sense from the thrift institutions, and so on.

The CHAIRMAN. This is not new to me. We had a hearing before the Joint Economic Committee on it and I am convinced, Mr. Fowler,

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that right here in broad daylight an awful scandal has gone on. These CD's were commenced in 1960 by just a few banks, a handful of big banks. They say, "you come to us." They say to the managers, "you come to us and we will issue CD's at 4 percent." That was quite a bonus and windfall because the short-term securities were much less than that. But they were overlooking the fact that there was a race between interest rates on short-term Government securities and CD's so that when December 1965 came around, the rates had gone up so high on Government short-term securities because big bidders had been enticed out of the bill market and went to the banks that were issuing these CD's.

I think that was an awful scandal and I think it was a great detriment to the public interest that it happened. Nobody seemed to say anything about it. They just let it go. But it happened right here and we could all see it.

Now, then, in December 1965, all the billions of dollars of CD's were coming due and the banks could not get any agreement out of the Federal Reserve to make them any loans or to do anything to assist in "rolling over" their CD portfolio. So they were hurting and they got on the Federal Reserve Board right quick. You know about that. You know that they were pressing to do something and the Federal Reserve Board finally raised the rate, not only the discount rate—that did not mean much here—but raised the CD rate from 4½ percent to 5½ percent. They defied the President of the United States who did not want it done, defied the Secretary of the Treasury who did not want it done.

In other words, the Federal Reserve, being the fourth branch of Government, acting on its own because it does not come to Congress to get its expenses, because it has a billion and a half dollars interest a year on those bonds to spend any way they wanted to and because they are not audited by the General Accounting Office. They just did an arbitrary act which I think was a terrible disservice to our country.

Do you not think it was a disservice at the time, December 6, Mr. Fowler?

Secretary FOWLER. My views on that incident are so well spread over the public prints and in the hearings of congressional committees, including the Joint Economic Committee, I think I would be taking the time of this committee to voice them here. I will be glad to say——

The CHAIRMAN. All right.

Secretary FOWLER. I will refer you to my most recent comment on this, when addressing the Reserve city bankers in Phoenix in April, I restated my views on this particular question to that audience. My views would be the same here today.

The CHAIRMAN. Are you saying, Mr. Fowler, that you are opposed to the action? I know that you were at the time, until January, but do you believe that the Federal Reserve should have a right to go contrary to the administration on matters of policy like that? Do you not think that the Federal Reserve should be brought back under the jurisdiction of the U.S. Government?

Secretary FOWLER. I think it is very important, Mr. Chairman, that fiscal, monetary, and debt management policies be coordinated.

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I think the question of the method and form of that coordination is a question which is one between the Congress and the Federal Reserve Board.

The CHAIRMAN. You mean the executive?

Secretary FOWLER. The President and the Secretary of the Treasury are going to do everything they can to make and work for effective coordination in this area under whatever ground rules for that coordination the Congress sees fit to establish. The existing ones or the changed ones. But I do not consider that I have the judgment or the background, nor do I think it would be appropriate, for me to advise the Congress as to the particular ground rules it in its judgment should fix under which this coordination will carry on. We are going to do our very best to coordinate under the ground rules, whatever they are. We are going to try to get along and work together with these independent bodies which draw both their supervisory and their monetary authority in the financial field directly from the Congress of the United States. They do not take them through the President. That applies to the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and to the Comptroller of the Currency who, for administrative purposes, is in the Treasury Department.

The CHAIRMAN. I have this suggestion to make. You have a law here that is 90 years old. You admit yourself that there is a great similarity between this interest-bearing currency that they are issuing right now and the notes that were being issued. It was supposed to stop 90 years ago. In addition you have the Employment Act of 1946, just as clear, I think, as a law can be written. And I think—my personal opinion—that the Chief Executive should consider seriously setting up a coordinating committee himself. I do not personally believe it is effective to put a number of people who are, we will say, of the same rank and the same category as yourself and the Federal Reserve Board, Comptroller of the Currency, FDIC—to have one of you do it—with all due respect to you. I do trust you and I think you are honestly trying to do a good job, but I do not think it is the right thing to do, to have the Coordinating Committee set up among you people who are not the top person, you are not the Chief Executive. I think the Chief Executive should consider setting up his own coordinating committee to where they would be responsible to him to make reports to him occasionally. I think that would be an effective coordinating committee.

Secretary FOWLER. Mr. Chairman, as you know, there is and has been such a body which is composed of four people: the Chairman of the Council of Economic Advisers, the Director of the Budget, the Chairman of the Federal Reserve Board, and the Secretary of the Treasury. In popular terms it is called the quadriad. That body meets informally with the President quite frequently. We have full and open discussions of the problems that the President wants to take up with this group. There is this existing instrument.

Now, as you well know, there are, of course, limitations of time on the range of problems that the Chief Executive and his financial adviser, the Secretary of the Treasury, can be concerned with.

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I do not think that the Congress can hold the Chief Executive responsible for policies and operations in a field where the Congress has created an agency and declared it to be independent.

The CHAIRMAN. I will challenge that right now. You show me the language in any law that Congress has ever passed that makes a declaration that the Federal Reserve should have this. You show me in the debates of Congress, House or Senate, where it was ever expressed that it was the intent that the Federal Reserve should be independent.

Secretary FOWLER. Mr. Chairman, I am using the word "independent" and I think you realize that I did not infer it meant independent from the Congress, but independent in that I can find no authority under which the line of command to these agencies goes through the President of the United States or the Secretary of the Treasury.

The CHAIRMAN. I would not take the time of that now. I challenge that statement, my dear sir, and I challenge Mr. Martin to present testimony just like you have. He has not presented it yet, nor has anyone else.

I will yield to Mrs. Sullivan.

Mrs. SULLIVAN. Thank you, Mr. Chairman. Mr. Secretary, according to a report in the April 15 issue of the American Banker, Under Secretary of the Treasury Deming in Houston, Tex., severely criticized Chairman Patman's bill to curb negotiable CD's.

Did these remarks have the official blessing of the Treasury?

Secretary FOWLER. I do not recall the remarks, Mrs. Sullivan, and I do not recall the circumstances. I would have to refresh my recollection on the text of the speech and confer with Secretary Deming who is out of the country at this time.

Mrs. SULLIVAN. Will you furnish an answer for our record after you have had a chance to talk with Mr. Deming?

Secretary FOWLER. Yes.

(The article referred to and Secretary Fowler's reply follow:)

[From the American Banker, Apr. 15, 1966]

DEMING CONCERNED OVER CD RATES, SEES PATMAN RX TOO STRONG

(Special to the American Banker)

HOUSTON.—Under Secretary of the Treasury Frederick L. Deming this week expressed concern over the "rapid buildup of rates on certificates of deposit." But, he said, he believes the proposal of Representative Wright Patman, Democrat, of Texas—to outlaw the certificates—is too drastic.

"The real concern" Mr. Deming said in an interview, "is that banks have continued to make these rates more attractive to the public. The question is how long this money will stick with them."

Withdrawal of an appreciable amount of deposits upon maturing of the certificates, after banks have made long-term loans, would pose liquidity problems for the banks, said Mr. Deming, former president of the Federal Reserve Bank of Minneapolis.

He said the run-up in rates on the certificates "has been greater than anyone could have anticipated," but he sees no need for going to the lengths of the proposal by Representative Patman, who is chairman, House Banking and Currency Committee.

"I don't think that the excesses have been such that you'd want to eliminate CD's completely," he said.

Mr. Deming said he has no ideas as to the amount of corporate funds which may have been shifted from Treasury issues into certificates of deposit. It

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would be too difficult a task for the Treasury to try to ascertain the extent of such shifts, he said.

The Treasury Under Secretary, who came to Houston to address a group of bankers and businessmen at a dinner preceding Thursday's annual meeting of the boards of the Federal Reserve Bank of Dallas and the Houston branch, also said:

He likes the general tenor of the proposed legislation, favored by Chairman J. L. Robertson of the Senate Banking and Currency Committee, to provide better scrutiny of banks and savings and loan associations.

Prospects for price stability in the economy look better, but there is still some strain on the Nation's resources that is creating inflationary pressures.

Approximately $12 billion will be drained out of the economy in the Government's fiscal 1967, starting July 1, as a result of monetary restrictions, fiscal measures, higher taxes, including those for medicare and President Johnson's wage-price guideposts and call for voluntary restraints.

No one expects corporations to drop all their plans for the 16-percent to 19-percent increase in capital expenditures forecast for this year, but "some of it." He declined to fix a percentage that he believes should be cut.

Higher taxes could be imposed if the Vietnam spending escalates, if Congress appropriates funds beyond those stipulated in the budget, or if inflation appears to be getting out of hand.

"I don't think," Mr. Deming added, "that he (President Johnson) would touch wage and price controls."

Mr. Deming said that while prices on "sensitive materials" have risen, and inflationary pressures continue, they "are nothing like during the Korean War." Prices on farm and food products appear to have been flattening out during the past month, he said.

(The following statement was supplied by the Treasury Department:)

Under Secretary Deming spoke informally in Houston, Tex., at the April 13 meeting of the joint board of the Federal Reserve Bank of Dallas and its branches. In his prepared remarks, no text of which was made available, Mr. Deming made no reference to Chairman Patman's bill, H.R. 14026.

In a press conference held in conjunction with the speech, Mr. Deming was asked by a reporter what the Treasury position was with respect to H.R. 14026. Mr. Deming replied that the Treasury Department had not taken a position with respect to the bill; however, Mr. Deming commented that he would like to make two points: First, that the Treasury Department was concerned with the certificate of deposit question, and second, that it was his offhand impression that Chairman Patman's bill went further than was necessary under present circumstances.

Mr. Deming's statement at the press conference in Houston is essentially the same position as that taken by Secretary Fowler in his testimony on May 19, 1966, before the Committee on Banking and Currency when he said: "While I do not favor H.R. 14026, I do not mean to say that we see no problems at all in the CD area, or that we have no concern about the current role CD's seem to be playing in the interest rate structure."

Mrs. SULLIVAN. Also, on the same interview, Mr. Deming is quoted as saying that it would be too difficult a task for the Treasury to ascertain the extent of shifts of funds from Treasury bills to CD's. Does this mean that the Treasury-Federal Reserve joint study of the Government securities market is really not being taken seriously by the Treasury?

Secretary FOWLER. No, I am sure it does not carry any such inference.

Mrs. SULLIVAN. Thank you. I would appreciate it if you would have a fuller answer to the first part of the question.

That is all, Mr. Chairman.

The CHAIRMAN. Mrs. Dwyer?

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Mrs. DWYER. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Secretary, I wonder if you could help me distinguish between negotiable CD's and the nonnegotiable CD's.

First, when we say nonnegotiable do we mean nontransferable or do we mean they do not pass to a holder in due course like a negotiable instrument? Are they transferable?

Secretary FOWLER. Rather than discuss this in technical, legal terms, Congressman Moorhead, I think, as a practical matter, you might have a small CD that would be dressed up and appear for all practical purposes to be negotiable, but would not in fact be negotiable, that is, you would run into difficulties in moving it around. The larger CD's are the ones that are really money market instruments. So I think really the negotiability has some relationship to size as well as to the express legal terms that may be there.

Mr. MOORHEAD. In the bill that you have submitted to us, do you contemplate the possibility of authorizing the Board and the FDIC to permit different—make greater differentials between negotiable and nonnegotiable CD's?

Secretary FOWLER. No, sir; we were trying to keep this just as simple as possible because it is addressed to a temporary transitional problem. Rather than deal with all the varying shapes of this problem, we have tried to keep it simple by providing authority to create a rate differential on savings, between savings up to the $10,000 mark, or the insured amount, and everything above that. That is the one distinction.

I think it might be of interest to you, sir, to inquire of the regulatory or supervisory authorities—the Federal Reserve Board and the FDIC—as to whether or not they already have the authority to make the distinction between the negotiable and the nonnegotiable type of CD. Where we have found in our discussions with them that they feel they lack the authority to move sharply is in terms of the amount of the instrument, and that is why this particular proposal goes specifically to differentials in terms of the amount of the deposit.

Mr. MOORHEAD. Mr. Secretary, I notice we have before us a table relating to the growth of negotiable certificates of deposit and up here we have a chart showing the growth of negotiable time certificates. I think it might be helpful——

Secretary FOWLER. These, I might say are not our products. They have another author, therefore I am not in a position to explain them.

Mr. MOORHEAD. Do you have tables that show the growth of nonnegotiable certificates of deposit?

Secretary FOWLER. We do not have it readily available. I do not know whether it could be pulled together or not. With respect to the charts and tables you mentioned, I am informed that they did come from the Treasury Department, but they are not here as part of my statement today.

Mr. MOORHEAD. I think it would be helpful in our deliberations if we could have tables, if they were readily available, to insert in the record. I would ask you to insert them in the record, Mr. Chairman.

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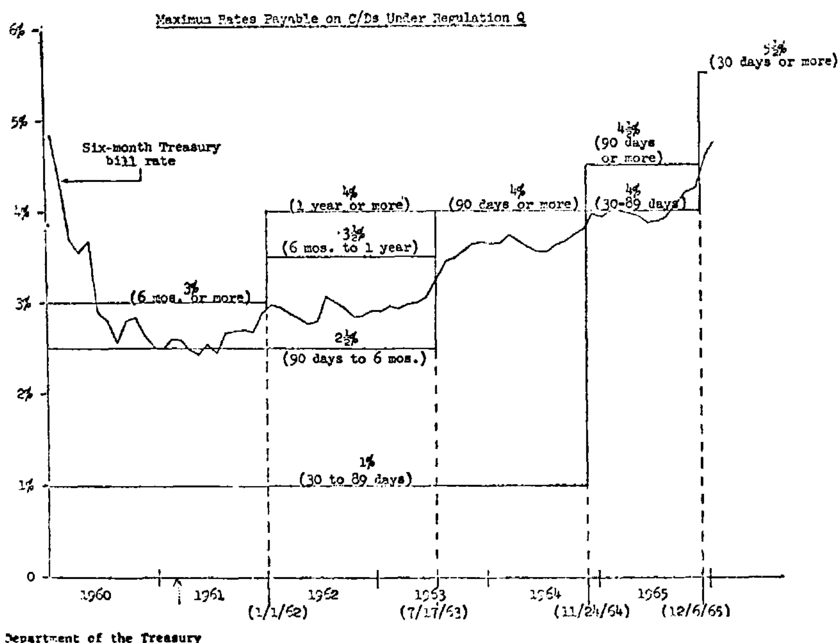
(The chart referred to follows; see also pp. 137–139.)



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Secretary FOWLER. I will be glad to make available whatever we have. I did not bring it along because rather than going over the entire range of this problem, Congressman Moorhead, I was trying to pick out one simple point.

(The following material was submitted for the record by the Treasury Department:)

The request for information on the growth of nonnegotiable certificates of deposit is not readily answered, since data bearing directly on this category are not available. Data separating savings and time deposits at all commercial banks are available from semiannual call reports, the latest applying to June 1965, but the call report data do not show nonnegotiable certificates of deposit as a separate item. Only a sketchy approximation of nonnegotiable CD's is presented in the following table, derived by subtracting savings deposits, and large-size negotiable CD's at weekly reporting banks from total time and savings deposits. The resultant numbers may represent the trend in nonnegotiable CD's, but the levels are overstated, and the trend itself may be somewhat distorted, since the figures obtained would include savings deposits of other than individuals, partnerships, and corporations, they would include time deposits, open account, and they would include negotiable CD's smaller than $100,000 or at other than weekly reporting banks.

A second table, "Types of Time and Savings Deposits, IPC, Held by Member Banks on Dec. 22, 1965," was taken from the Federal Reserve Bulletin of April 1966. Using information obtained from a special study undertaken in late 1965 and early 1966, it classified time deposits of individuals, partnerships, and corporations by type of deposit.

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Commercial bank time and savings deposits

[In millions of dollars]

	Total time and savings deposits [1]	Savings deposits of individuals, partnerships and corporations [2]	Negotiable CD's [3]	Remainder including non-negotiable CD's [4]
December 1961	82,909	63,858	2,782	16,269
December 1962	98,244	70,967	5,442	21,835
December 1963	111,590	76,303	9,579	25,708
June 1964	120,264	79,327	11,687	29,250
December 1964	127,539	82,922	12,585	32,032
June 1965	138,399	87,317	15,276	35,806

[1] Includes time deposits of States and political subdivisions, domestic banks, foreign banks and official institutions, U.S. Government and postal savings.
[2] This breakdown is available for all commercial banks from call report data beginning with June 1961. The call report for December 1965 is not yet available.
[3] The negotiable CD data were obtained from reports of the weekly reporting member banks and are for denominations of $100,000 or more. This category includes negotiable CD's held by individuals, partnerships and corporations, as well as others.
[4] Derived by subtracting 2d and 3d column from 1st column.

Source: Federal Reserve and Treasury estimate.

Types of time and savings deposits, IPC, held by member banks, on Dec. 22, 1965 [1]

Type of deposit	Number of banks		Amounts held	
	Reporting specific types	Percentage of all member	In billions of dollars	Percentage distribution
Savings deposits	5,893	95	74.4	70
Savings certificates	2,773	45	6.6	6
Savings bonds	130	2	0.4	(2)
Other nonnegotiable CD's	2,157	35	5.1	5
Negotiable CD's	1,777	29	15.9	15
Time deposits, open account	1,763	28	4.4	4
Total			106.8	100

[1] Time deposits of individuals, partnerships, and corporations.
[2] Less than one-half of 1 percent.

Source: Federal Reserve Bulletin, April 1966.

Mr. MOORHEAD. I realize that the big negotiable CD's also have a related effect on the smaller ones and I think maybe some of the tables might bring that out if it is true.

Mr. Secretary, I note on page 12 of your testimony, and then I note also in glancing at the bill that you very kindly provided, authority is given to the Federal Reserve Board and to the FDIC to control rates in these different ranges. My concern, sir, is, should not this authority be centralized in one agency—one or the other so that it would be uniform? Is it not important to have the rates for the member banks the same as the rates for the nonmember banks and do we not run a danger by dividing authority? In the banking agencies everything has not been uniform in the past.

Secretary FOWLER. You do, Congressman, run such a danger and you will continue to run such a danger as long as the structure of delegation of authority to these supervisory institutions is as the

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colloquy between the Chairman and I indicated. We might have a difference in emphasis here, but I think the present arrangements do place a very high premium on voluntary coordination between the various bank regulating bodies and in this particular case you would be depending upon the FDIC and the Federal Reserve Board to arrive at some meeting of minds as to the appropriate level. It was certainly implicit in my submitting this proposal as to the appropriate level that, in the course of these hearings, either formally or informally, this would not be left entirely to chance.

Mr. MOORHEAD. Mr. Secretary, if Congress decided that this issue that is presented by the bill that you have presented to us is essentially more of a monetary problem than it is the safety and soundness of the banking system, would it not be possible for us, if we so chose, to put all of the authority into the hands of the Fed?

Secretary FOWLER. Well, I think you would perhaps lodge the authority—this is something of a technical question—you could probably lodge the authority in the FDIC, but make clear, either in the committee report or in the language in the bill itself, that in exercising this particular authority to the nonmember banks, the FDIC would follow the pattern set by the Federal Reserve Board in dealing with member banks.

Mr. MOORHEAD. You said put it in the FDIC—I thought about it the other way around.

Secretary FOWLER. By directing the FDIC, in exercising its authority in this particular area, to achieve conformity with whatever was set by the Federal Reserve Board.

Mr. MOORHEAD. Thank you.

The CHAIRMAN. Mr. St Germain?

Mr. ST GERMAIN. Mr. Secretary, in your testimony you make recommendations of 5 percent on time deposits up to $5,000. Would that, in essence, be a help to the savings and loan institutions and savings banks in view of the fact that their funds are repayments on mortgages they are now holding—many of them are 4½- or 5-percent mortgages. How could they afford to pay 5 percent on these time deposits?

Secretary FOWLER. Now, as for the savings and loans and mutual savings banks, of course, what they choose to pay is up to them now. The purpose and effect of this bill, if enacted, sir, would be to prevent the commercial banks from offering beyond 5 percent to the small saver, the fellows whose deposits have gone up to as high as the $10,000 insured limit. It is my information—but this is something that the committee could inquire into—that this is about the top of the range that the savings and loan institutions could afford to pay.

Mr. ST GERMAIN. Do you feel they can pay them?

Secretary FOWLER. It would help some more than it would others. I think it would help most clearly those that are in an area where there are commercial banks already offering CD's to the small saver at 5 percent or more. It would equalize rate competition more or less at the 5 percent level. In areas where that was not the case, and savings and loans and mutual savings banks were still receiving deposits and getting a degree of growth at lesser rates, it certainly would not help institutions in that particular situation.

Mr. ST GERMAIN. Nothing further.

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Mr. OTTINGER. Would the gentleman yield for one question?

The savings and loan associations testified that they could not afford to pay higher rates, such as 5, 5½ percent, because of this mortgage situation. I just wondered whether it would be a practicable solution to permit them to do so and whether they cannot, in fact, afford to do so. This is a means by which they themselves get their funds, through these mortgages.

Secretary FOWLER. I think they would have to speak for themselves on this. I have some impression that, while in this world one never gets all that one would really like to have in the way of a sure situation, there is some feeling on the part of these organizations that this would be helpful. It would retard or arrest the outflow—they said they need something to arrest the hemorrhage.

Mr. OTTINGER. In your response to Mr. St Germain's question there is some confusion. Did you intend that the savings and loan associations be allowed to charge a higher rate or did you intend that we should curb the rate of interest which the commercial banks could charge on CD's?

Secretary FOWLER. We are dealing with what the commercial banks can do on CD's. What the savings and loan institutions should be permitted to do is a matter for the Federal Home Loan Bank Board and I think that you would want to hear from Chairman Horne on that.

Mr. OTTINGER. The purport of your suggestion on page 10 is that the Federal Reserve should set a lower rate of interest on small denomination CD's. In other words, go back to regulation Q. Is it not that the savings accounts should be allowed to go up?

Secretary FOWLER. Not at all.

The CHAIRMAN. Have the gentlemen finished?

Mr. ST GERMAIN. Yes.

The CHAIRMAN. Mr. Halpern?

Mr. HALPERN. Mr. Chairman, I would like to commend the Secretary for his analytical and perceptive and most informative presentation here this morning. I, for one, would have to evaluate the views he offered before I make my mind up on this legislation.

I am pleased to note that the Secretary thinks that the bill to ban CD's outright is drastic action. I feel such action could well be an invitation, Mr. Chairman, to financial crisis.

While I have the opportunity, Mr. Chairman, I would like to commend the distinguished Secretary on the superb job he is doing. Mr. Secretary, in little more than a year that you have been at the helm of the Treasury Department, in my opinion and in the opinion of others, you are proving yourself to be one of the Nation's great Secretaries of the Treasury and I wish to compliment you.

Secretary FOWLER. Thank you very much, sir.

Mr. HALPERN. That is all, sir.

The CHAIRMAN. Let me get this straight about your bill, Mr. Secretary. If I read this correctly, it will permit, not require the Federal Reserve to arrange these rates in a way so that up to the $10,000 insurance limit, no more than 5 percent interest can be paid on time deposits, including negotiable CD's, and that this is the same for sav-

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ings and loans. But above that they can continue to pay up to 5½ percent; is that correct?

Secretary FOWLER. That is correct.

The CHAIRMAN. Is that not a definite discrimination against the poor man?

In other words, two people come to your window if you are a banker. One of them has $100,000 and they say we will give you 5½ percent and the man who has only $10,000, they say we will give you only 5 percent.

Secretary FOWLER. Some may view it as such, but as my statement indicates, while it is very difficult to draw the line in any given amount and give a compelling rational justification for it, the one that we have fixed upon is that the depositor who comes to the bank and makes his deposit under the terms and conditions where there is absolutely no risk is not in the same position as the depositor who comes and puts his money with the bank and takes a risk.

The CHAIRMAN. Do you consider there is a risk above $10,000?

Secretary FOWLER. There is always a risk, Mr. Chairman. I am happy to say that I do not think that in view of the character and nature of our financial structure and the supervisory authority that is exercised with relation to it that it is a very major risk. I think it is a very, very minor risk, indeed. But for the logic of a differentiation, I think this is just as good a logic as any.

The CHAIRMAN. If you are trying to make an excuse, it is fine.

Mr. Gonzalez?

Mr. GONZALEZ. Mr. Secretary, referring back to the page 10 that Mr. St Germain referred to in your first recommendation, I might preface my remarks by saying that last week I said, and I repeat here today, that it looks very much to me that we are federalizing the loan sharks, that up to now they have been pretty much compartmentalized on the State level. We lost the fight on the State level and it looks to me we are losing it at the national level.

You speak here of a 5-percent maximum rate on time deposits up to $10,000. Now, just exactly how would this proposal help solve the liquidity problem of the few large banks that have the most outstanding CD's?

Secretary FOWLER. It is not addressed to that. It is not addressed to that in any particular. I am here concerned with what I think is the most immediate problem before this committee, the one that requires the promptest attention, and that is something that will retard or arrest the outflow of funds from the savings and loan organizations and the mutual savings banks to those who offer 5 percent or beyond in rates of interest for so-called time and savings deposits.

If I can be perfectly clear on one thing, I did not come down here today to deal with the whole range of banking problems and all of the aspects of the CD's. I am trying to pinpoint in my testimony this one problem and suggest that this is one which the committee ought to give first priority to, if I may respectfully do so.

Mr. GONZALEZ. But you place this as your first recommendation. This is the first one that you mention, is it not, on page 10?

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Secretary FOWLER. This is the only one. I indicated that in the last paragraph in the statement:

> Finally, I would like to emphasize just as strongly as I can that these proposals are not a cure-all or a permanent attempt to deal with the problem of competition in the financial area.

There are many other aspects to this problem that the committee will be concerned with.

Mr. GONZALEZ. That is true. Somebody has submitted the proposition that 95 percent of the negotiable CD's are in denominations of $100,000 or better. So then how is this in any way in your specific remedy to address yourself to the problem as you say?

Secretary FOWLER. I would like to, if I may, refer you to one aspect of the statement.

Mr. OTTINGER. Will the gentleman yield?

Secretary FOWLER. Bear with me just one moment here.

Mr. OTTINGER. Will the gentleman yield for just a comment on that?

Mr. GONZALEZ. Let us not permit him to stray from this question.

Secretary FOWLER. On page 8, sir, the only comment that I offered was this:

> I cannot conclude that a flat ban on negotiable certificates of deposit would be desirable. If, in the judgment of the Committee, some action is deemed desirable, a better approach might lie in the direction of providing the appropriate monetary authorities with greater discretion to set levels of reserve requirements on large negotiable certificates of deposit that might exceed those on other time and savings deposits. Of course, you will want to consider carefully the views of those much closer to the problem of day-to-day bank supervision.

Now, I think that is the only part of the statement that is really responsive, sir, to your question about how to deal with other phases of the problem. The single one we are pinpointing here is the so-called small savings flow. I wanted only to voice a preference to indicate that I thought a flat ban would be undesirable and drastic, and that my preference would be to move in giving the monetary authorities a right to vary the reserve requirements in relation to the different character and amount and maturity of some of these instruments.

Mr. GONZALEZ. I realize that you are not making a sort of shotgun approach to this. I do not think it lends itself to it anyway. But I hate to see ourselves get into this sort of thing on interest. There is no question—it is obvious that there is an aspect of savings and loans versus banks and banks versus savings and loans and so forth. In the meanwhile I am afraid that the overall public interest is being overlooked. This is what I am concerned with and your suggestion, as the Chairman so aptly pointed out, penalizes the small saver.

My time is up.

The CHAIRMAN. Off the record.

(Discussion off the record.)

The CHAIRMAN. Mr. Minish?

Secretary FOWLER. With your permission, I would supplement my comments to Congressman Gonzalez by directing his attention to pages 13 through 18 of the report of the Committee on Financial Institutions

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to the President which was released in April 1963. It deals with the question of reserves on time accounts and the conclusion of the Committee. I will quote:

No. 3. The Committee with one member dissenting favors the continuation of reserve requirements on time and savings deposits at commercial banks and the introduction of a similar reserve requirement for shares of savings and loan associations and deposits of mutual savings banks. In addition Federal agencies that supervise financial institutions should be endowed with sufficient authority to assure that the institutions maintain adequate liquidity over and above cash reserve requirements.

I think that general conclusion and the reasoning that led up to it are pertinent to your particular question and that was the background for the comment that I made that I think the dangers that may exist in terms of large CD's go most importantly to the question of preservation of liquidity and therefore, the authority of the regulatory bodies to fix differing reserve requirements which have some relationship to the liquidity. Preservation of liquidity is the heart of the problem.

Mr. GONZALEZ. The Federal Reserve System in its 1952 report, in one of its recommendations asks for an extension of its authority over all insured banks to control reserves. So I imagine this would be in line with the recommendations that you referred to here in the committee's reports, or is there any similarity between the two?

Secretary FOWLER. I have not compared the two to determine whether they are the same or whether there are differences, sir.

Mr. GONZALEZ. The Federal Reserve System said they had a pretty high rate of withdrawals from the System. This has created a bad situation and they are asking for additional authority to cover their reserve regulatory authorities over all banks.

Secretary FOWLER. Over nonmember banks. This is a separate question from the one that this report is addressed to, although I think the matter is covered in another part of the report.

Mr. GONZALEZ. Thank you very much.

The CHAIRMAN. Mr. Minish.

Mr. MINISH. Mr. Secretary, is it lawful under our tax laws for commercial banks to take money received from CD's and invest in tax-free municipal bonds, taking as an income tax deduction the interest paid on CD's to large corporations? Is this legal or is it right?

The CHAIRMAN. Let me see if I understand that.

Secretary FOWLER. I would like to hear that question again, too.

The CHAIRMAN. You are asking whether a bank can pay say 5 percent on CD's, the interest being tax deductible, and then take that money, which really costs them only about 2½ percent considering their tax bracket, and invest it in municipal bonds at say 4 percent. Of course the 4-percent returns from that would be tax exempt and your question is, whether or not that is legal, to get that windfall? I guess it would be considered a windfall.

Secretary FOWLER. I would like to think about your question and give you a considered answer.

(The following statement was submitted by the Treasury Department:)

EXPENSES RELATING TO TAX-EXEMPT INCOME

A question has been raised as to whether commercial banks may use the proceeds of certificates of deposit to invest in municipal bonds, the interest on

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which is exempt from Federal income taxation, and deduct the interest paid on such certificates of deposit.

The Internal Revenue Code provides in section 265(2) that interest on indebtedness incurred or continued to purchase or carry obligations, the interest on which is exempt from tax, is not deductible. This provision was enacted to prevent the double benefit that would otherwise ensue from such borrowing and investment in municipal bonds. Were section 265 not the law, the exempt income would not be taxable, and in addition, the interest on obligations incurred or continued to receive tax-exempt interest would be deductible.

In the light of its legislative history, the provision has been interpreted to permit commercial banks to deduct the interest on time deposits. Certificates of deposit of commercial banks, because of their similarity to time deposits, have been treated in the same manner. Of course, interest on nondeposit obligations of banks, such as notes and debentures, incurred or continued to carry or purchase tax-exempt obligations is not treated in the same manner as interest on deposits.

Mr. MINISH. Mr. Secretary, just recently the Government speeded up the withdrawal rate of withholding tax payment. What have you been doing to get some of this money from the tax loan accounts where I recall 4 or 5 years ago they had $5 billion?

Secretary FOWLER. Secretary Dillon made a complete study—I cannot remember the exact time—I believe I was out of the Government at the time, but I have a recollection that a study was prepared listing the relationship between the various services provided by the banks and the benefits received by the so-called tax and loan accounts arrangements. I will be glad to supply you with a copy of that report which was my predecessor's explanation and comment on the subject. I have not——

Mr. MINISH. I was going to ask you about that later on because at a hearing here some years ago he said that the Department was making the study but we never received it.

Secretary FOWLER. Such a study has been prepared and has been available for a year or two.

Mr. MINISH. Recently did you call in some funds from that?

Secretary FOWLER. We are constantly drawing them down. That is the way all the bills get paid.

Mr. MINISH. Are you going to continue to?

Secretary FOWLER. Well, the balances go up and down. As taxes are paid the tax and loan account goes up at a particular bank, and as we pay bills to various contractors, or salaries of Government employees, the balances go down. They got down as low, I think as $1.5 billion on April 20.

Mr. MINISH. Are you going to keep it down?

Secretary FOWLER. The money just keeps coming in. You cannot keep it at a given level. The ebb and flow of these accounts is an inescapable consequence of the ebb and flow of Government outpayment and Government inpayment. For example, at the four periods of the year when corporations make their tax payments we have considerable amounts of cash. At the time when the quarterly payments are made on the individual income tax we also have a considerable amount.

Mr. MINISH. You cannot keep it at a minimum.

Secretary FOWLER. There is a constant effort on our part to do so and one in which a sister committee to this one, the House Ways and Means Committee gives us a good going over—and will next Monday in considering the debt-limit legislation.

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Mr. MINISH. On page 9 of your statement:

While none of us is in a position to evaluate just how serious this threat may be as a long-term matter affecting these institutions, there is a genuine current concern in the Congress, in the Federal Home Loan Bank Board, and in the private economy, that a continued savings outflow could place undue stress on some of these financial institutions, and undue constraints on the flow of money into the mortgage market and homebuilding.

I have a letter here that shows how serious the problem is. This is a savings and loan institution in Newark, N.J., and I received this yesterday.

Permit me to present the facts from the records of our own association. During April 1966 the total sum of $2,794,963 of savings was withdrawn. Of this total we, by inspecting the endorsements of the returned withdrawal checks, have traced the use of course of $1,118,760. Of this traceable amount of $1,118,760, we find that $509,372 or 45.53 percent was delivered to one, and only one, of the commercial banks of Newark, which since last fall and persistently to the present time has advertised to the public issuance of certificates of deposit at a 5-percent yield.

Secretary FOWLER. I think that is an example of what I fear is going on in many other areas.

Mr. MINISH. That is all, Mr. Chairman.

The CHAIRMAN. Mr. Harvey.

Mr. HARVEY. Thank you, Mr. Chairman.

Mr. Secretary, I get the impression that back in Michigan at the grassroots of my district this is quite a critical situation; that actually, it could very sharply curtail home building and apartment building in the months ahead. I have the impression, also, that some of the savings and loans and other institutions such as that are acting in sort of a psychology of fear. In other words, even though they have money to lend, they do not know what is going to happen at the end of the next quarter because of a shift in funds, and so forth, so they are not real anxious to loan those funds out. Up until now in our hearings, I will be honest with you, I have felt as you did, that the chairman's bill would bring about financial chaos as I suggested one day. I have leaned toward H.R. 14422. I noticed in your testimony this morning that you oppose that particular bill, but yet I note that in your bill the approach is pretty much the same, is it not?

Secretary FOWLER. As a matter of fact, I think I said I have considerable sympathy with the apparent objectives of H.R. 14422, and I think the two bills are trying to achieve somewhat the same objective. But it did seem to me that the approach of that bill would be unnecessarily rigid and that it involves unnecessary discriminatory action against smaller savers at commercial banks under the present interest rate spread.

Now, you will find a continuing emphasis in my comments on the temporary transition period. I would hope someday that we would go back to a situation in which the spread between what the passbook saver gets for his or her money and what others get for larger amounts, would be not nearly as great as it is today. But under the current circumstances it would seem to me that to push all the savings back to the 4-percent level for the so-called small saver would be too drastic.

(Mr. Ashley now presiding.)

Mr. HARVEY. I would certainly want to think your bill over and know more about it, and how it is going to affect the various institutions

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and so forth. I personally feel that it is the approach to take with the limited knowledge that I have at this time. While we have you here, Mr. Secretary, I did want to ask you a question or so in the time I have about the balance-of-payments problem.

Secretary FOWLER. Are you going to get into that?

Mr. HARVEY. Just touch on it.

Secretary FOWLER. Let me get my——

Mr. HARVEY. You do not have to get the briefcase out or anything.

Secretary FOWLER. I always like to get the briefcase out on this.

Mr. HARVEY. I have read in the paper recently since we can expect that our balance-of-payments deficit will be somewhat in the neighborhood of $2 and $3 billion this year. This is far in excess, of course, of what we had expected earlier. Then I recall reading of the speech you made in Phoenix not so long ago about some of these voluntary restraints on oversea investments in bank lending and you are suggesting that they would be continued for the duration of the Vietnam war.

Now, I think in all fairness that we in Congress here have been led to believe that these voluntary restraints were going to be temporary.

Secretary FOWLER. They are temporary, Mr. Harvey. Just as the war in Vietnam is temporary.

Mr. HARVEY. By temporary you mean they are as temporary as the war in Vietnam?

Secretary FOWLER. My judgment at this time is that it would be foolhardy to abandon these voluntary programs while we are at war in Vietnam. And in making the statement I did in Phoenix and I noticed some considerable comment from others about that—I would like to be very clear that we do not view these voluntary programs as a part of any permanent, long-lasting solution of this particular problem. I do not see them as part of it.

Mr. HARVEY. They are semipermanent?

Secretary FOWLER. No, no, let us be clear about this. If you would read, and I would be glad to provide you with a copy of my statement yesterday on the first quarter balance of payments in detail, I think there is a general understanding in many circles, and in financial circles throughout the world, that a very special strain, and special difficulties, are created for a country in maintaining equilibrium, or attaining equilibrium, in the balance of payments while it is carrying on military activities on the scale we are.

Mr. HARVEY. That is my next question. I know that the reasons you have given are the fighting in Vietnam, but really, is not this a classic case of inflation where the imports go up and the exports go down?

Secretary FOWLER. There are two factors that my statement developed yesterday. There is the direct cost to our balance of payments from expenditures in southeast Asia. And I do not give any maximum figure to that, but I say we can very definitely account for something in the neighborhood of $700 to $750 million of direct outlays. Our balance of payments would be running at an annual rate that much less if that activity were not going on.

Then there is the indirect cost. Now the indirect cost is reflected in several ways. You have to ask yourself just to make it simple,

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what would the gross national product have been in the first quarter under a situation in which there were no Vietnam?

Mr. HARVEY. Let me just ask you—I have only a couple of minutes. I wanted to touch on a couple of things. If our deficit exceeds the $2 billion figure, what effect do you think this will have, if any, on the negotiations to create an international unit of monetary exchange?

Secretary FOWLER. It should not have any at all. I did not say it would not—I said it should not have any at all. And I would hope that those with whom we are negotiating will understand.

It should not have any effect at all because this is a contingency planning exercise to create a mechanical arrangement and an agreement and understanding by which, when additional liquidity needs to be provided from sources other than the deficits in our balance of payments it can be done quickly and in an orderly way.

These arrangements take years to create, as the present discussions and negotiations indicate. Therefore in my judgment it would be very unwise to set aside or put these negotiations on the back burner, because the war in Vietnam which is the root now of our problem in getting to equilibrium could end without relation to any particular timetable. This is not a prediction, this is simply the recognition of the fact that it could happen.

Mr. HARVEY. Was not the international negotiations toward this new unit the reason, chiefly for requests for voluntary restraints?

Secretary FOWLER. No indeed. Your time sequence is away off. The reason for the voluntary restraint program was because of a very sharp upsweep in outflows in 1964—foreign bank credit went up $2.5 billion in 1964. The rate of direct investment outflow went up very sharply and we had over a $1 billion deficit in the fourth quarter of 1964. It was only in July of 1965, in some remarks that I made at a meeting, that the United States invited, and you might say initiated, the course of moving out of discussion into concrete negotiations on international monetary affairs. A contributing factor toward making that request, or that suggestion, one that would be entertained was the clear demonstration through the voluntary programs that we did have control of our balance-of-payments situation.

Mr. HARVEY. In your judgment, Mr. Secretary, do you consider the restraint on business investment abroad to have been any success?

Secretary FOWLER. I think we have received excellent cooperation from the banks and nonbank financial institutions. I think we have received excellent cooperation from companies operating abroad and I do consider the voluntary programs to have been successful and to have substantially moderated outflows which would have otherwise made our deficits during the period since last February quite a different order of magnitude.

Mr. HARVEY. One other question and I will finish. Has your Department made any decision with respect to tourism?

Secretary FOWLER. That was discussed to some extent yesterday at the press conference. I think I am repeating myself fairly accurately where we said we are staying with the current program. We have to intensify and improve the effort to encourage foreigners to tour the United States and the effort to have U.S. citizens stay at home and see their country. We are forgoing any imposition of a head tax, or

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any other restrictive policy by Government act on the right of a citizen going where he or she pleases.

Mr. HARVEY. Thank you very much, Mr. Secretary. You can be certain that we will give very careful consideration to the bill which you suggested here which would appear to be a very thoughtful approach to the problem.

Secretary FOWLER. Thank you, sir.

Mr. ASHLEY. Mr. Weltner?

Mr. WELTNER. Thank you, Mr. Chairman. Mr. Secretary, I read your statement quite carefully and I think you very aptly put it on page 10 where you characterize the bills pending before this committee as "permanent arrangements that would compartmentalize our financial markets." They would be just that. I think if we pass these bills it might forestall some natural change in the market where funds could come from the bank and go back into savings and loan associations. Then we might have to come back and undo it. I think it is wise that the Congress not place rigid restraints upon temporary conditions.

Now, it appears to me, though, that your recommendation of a maximum rate on the maximum insured amount of deposit, with the existing regulation rates on the excess, is not really a goal that has to be accomplished by legislation. Why can't the Federal Reserve simply amend its present regulations to provide that? If that were done, if the circumstances changed, then we do not have to come back and approve, in both Houses of Congress, remedial legislation.

Secretary FOWLER. I would prefer the answer to that question to come from the Federal Reserve Board spokesman. My information and impression—arrived at by serious meeting and discussions in December and January and February—is that the Board's legal advisers consider it without authority, as they understand the current law, to fix rate differences based on the amount of deposit.

Mr. WELTNER. If that is the case, Mr. Secretary, then it would certainly answer my question. However, it seems sort of strange to me that we have an agency of Government empowered to make decisions but——

Secretary FOWLER. Without assuming the role of a lawyer—I could at least read the provision of the statute to you—this is 12 U.S.C. 371:

(b) Rate of interest to time deposits

The Board of Governors of the Federal Reserve System from time to time shall limit by regulation the rate of interest which may be paid by member banks to time and savings deposits and shall prescribe different rates for such payments to time and savings deposits, having different maturity, or subject to different conditions respecting withdrawal or repayment or subject to different conditions by reason of different locations, or according to the varying discount rates of member banks in the several Federal Reserve districts.

There is no reference to amount.

Now, our proposal here would insert at that point in the law this language:

In addition to the above, the said Board may prescribe the limit on the rate of interest which may be paid on that part of any time or savings deposit that does not exceed the maximum amount that may be insured by the Federal Deposit Insurance Corporation, lower than the limit prescribed for that part of such deposit that exceeds such amount.

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Mr. WELTNER. Is not the character, being fully insured up to $10,000, a different condition of repayment?

Secretary FOWLER. This is something you have to pursue with the Federal Reserve Board.

Mr. WELTNER. Mr. Secretary, if we passed a bill such as this, is there any assurance that the Federal Reserve Board would promulgate a new order under regulation Q that would make that differential in the interest rate based upon the maximum insured amount?

Secretary FOWLER. The clear inference of my statement is, in the processes of legislation, either through open testimony or other communications, that the Congress would assure itself of that fact.

Mr. WELTNER. Thank you, Mr. Secretary. I have sat on this committee for almost 4 years now, and I have often heard our distinguished chairman direct himself to the question of the response and the receptivity of the Federal Reserve Board to the desires and wishes of Congress. Based upon that "conditioning" I am not exactly sure, were we to adopt such a bill and have a full acceptance of your proposal, that that would indeed be implemented by the Federal Reserve.

Secretary FOWLER. Lacking such assurance you might want to make it mandatory for the first year.

Mr. WELTNER. And make a "permanent arrangement" in our financial market; would we not?

Secretary FOWLER. You would be so involved.

Mr. WELTNER. Thank you, Mr. Secretary.

Mr. ASHLEY. Mr. Todd?

Mr. TODD. I wonder if he should suggest that members of the committee sit on the Board as far as this regulation is concerned.

Mr. WELTNER. We have one member of the committee who has tried to sit on that Board.

Mr. ASHLEY. In his absence we need not continue this any further.

Mr. TODD. Mr. Secretary, I appreciate your coming before us this morning. I have a number of questions that I would like to ask.

Did the Coordinating Committee on Bank Supervision review your proposal and proposed bill that you have?

Secretary FOWLER. Not as such. I have a meeting scheduled for this afternoon in which I expect to do that, but the chairman indicated that the committee would not be meeting tomorrow and since I am dedicated to the debt limitation hearings before the Ways and Means Committee on Monday. I had to come in today without the benefit of consultation with the Coordinating Committee as such. I have discussed this with some of the individual members, however.

Mr. TODD. I wonder if there has been any discussion of the 5-percent rate which you are proposing? Chairman Horne's letter did not discuss this and it is my impression that this is too high a rate for some savings and loans to live with.

Secretary FOWLER. I do not believe that I could add anything to the committee's understanding of what the position of the Federal Home Loan Bank Board, Federal Reserve Board, or FDIC would be on this question.

Mr. TODD. I think it is important to us if we are to establish some rate that we have an accurate knowledge of the impact of this particular rate on the savings and loans. My own impression, based on my own discussions with those at home, would be that 4¾ would

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be about the maximum they could live with. It would seem to me we should have some accurate expression from the Coordinating Committee or the Home Loan Bank Board as to this interest rate. That is why I wondered if you had an opportunity to discuss it with them.

Secretary FOWLER. No.

Mr. TODD. It is a matter of policy that you are bringing up here.

Secretary FOWLER. There are a great many questions about this situation on which I would like to have a great many more answers than I currently do. But it was something, as I indicated, that had to be done in fairly short order and I submitted it here as an approach and as a principle and as an attack. I think it is important that you try to keep it simple. You are never going to get something that is going to please everybody, and you want to get something that is going to help and that you can get through.

Mr. TODD. What would you think of the idea of establishing say, a 6-month minimum for the maturities of CD's? Would this assist?

Secretary FOWLER. I think the authority for that already exists and therefore the concern of the committee should be, why does not the appropriate authority exercise that existing authority to amend the regulations in that fashion?

Mr. TODD. I think your suggestion that this authority be utilized by the Fed is an excellent suggestion. I would be concerned that we on the committee not get involved in making piecemeal decisions as far as monetary policy is concerned. I do not think we can address ourselves to this too well.

I wonder if you have any information or any opinion, rather, as to whether the rate in regulation Q, the interest rate in December was primarily in response to a liquidity problem or an attempt to slow down an overheating of the economy?

Secretary FOWLER. I did not engage in any discussion, nor was I aware, prior to the action, of the exact nature of the action that was contemplated. My discussions had to do with whether any action should be undertaken at that particular time. I was in no way aware of, nor did I have, nor can I give you any authentic background of, the purpose and motivation.

Mr. TODD. In connection with this problem, I wondered if it would also be appropriate for the committee to discuss whether or not reserve requirements could appropriately be raised on CD's, that this would make them a less expansionary influence in the economy?

Secretary FOWLER. I tried to raise that, and did raise it in my statement. I referred to it before.

On page 8 you will find the first full paragraph suggesting, "if in the judgment of the committee some action is deemed desirable, a better approach might lie in the direction of providing the appropriate monetary authorities with greater discretion to set levels of reserve requirements on large negotiable certificates of deposit that might exceed those on other time and savings deposits. Of course, you will want to consider carefully the views of those much closer to the problem of day-to-day bank supervision."

I do not feel really qualified to deal with that in any depth or with any precision. But I think this is in the line of approach, certainly, that would appeal more to me than outlawing the CD's completely as the other bill did.

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Mr. TODD. In this one, if the reserve requirement were raised, it would reduce the liquidity problems as they come due?

Secretary FOWLER. That is right. That is why I made reference to the commentary in the report of the Committee on Financial Institutions in April 1963, which I think indicates that one of the important elements in this entire picture is concerned with adequate instruments to deal with the liquidity problem. This is not true only of the commercial banks. I would like to take this opportunity to call to your attention the fact that on September 20, 1965, I submitted to Congress a proposed bill to provide for an increase in the maximum amount of insurance coverage from $10,000 to $15,000 on deposits. In the letter of transmittal I made it very clear the recommendation was made only on condition that a number of steps would be taken to protect further the safety and the liquidity of the financial institutions whose ability to attract funds from the public would be enhanced by the increase in deposit and share insurance coverage. The bill I submitted contained a number of important provisions designed to accomplish these objectives. For example, it provided adequate authority to the Federal Home Loan Bank Board to insure the maintenance of insured associations. It would make liquidity requirements applicable to the total of withdrawable accounts and borrowing, rather than the withdrawing alone, and would improve accounting and enforcement conditions.

The overall question of liquidity that is raised has its counterpart in the savings institutions. At the conclusion of the report of the Committee on Financial Institutions to which I referred earlier, the question of reserves for time deposits is taken up. It goes beyond this temporary question we have here involving withdrawals from savings and loan institutions. It is one which I would hope the committee could shortly turn its attention to both in the question you raise and also the pending bill that is before the committee dealing with increasing the maximum amount of insurance coverage.

(Mr. Todd subsequently submitted the Report of the Committee on Financial Institutions, which may be found in the appendix beginning on p. 712.)

Mr. ASHLEY. Mr. Mize?

Mr. MIZE. Mr. Secretary, would you care to conjecture on what the financial situation of the country would be and would have been had the Federal Reserve not done what it did in December?

Secretary FOWLER. No, I would not particularly care to comment on that. I think that in answering questions of the chairman I have commented on it many times. I would only say that in perspective, I think that it is fairly clear that a policy of monetary and fiscal restraint was indicated at the time the action was taken. We were in the throes of considering what combination of fiscal and monetary policies would be appropriate. We felt that the information that would become available in the month of December having to do with the budget figures for the remainder of fiscal 1966 and for fiscal 1967 which would encompass the whole Federal program as far as we could see it was essential. The better course would be in the light of that sum total of information, to try to arrive together in a coordinated fashion as to the proper mix and methods and choice of means of fiscal and monetary restraint that would be appropriate under those circumstances.

As I have indicated, I was not successful in prevailing—my advice was not accepted and the Board moved in the field of monetary re-

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straint. Then, as subsequent comments have been made clear, the President announced shortly thereafter, we were going to accept that action as a fact of life.

Mr. Mize. Well, would you care to conjecture on what you feel might be a situation if the action that was taken by the Federal Reserve in December was rescinded?

Secretary Fowler. I think that as I have indicated before, in testimony before the Joint Economic Committee, that this is a time in which a moderate measure of both fiscal and monetary restraint is appropriate and has been appropriate to the situation for these many months.

Mr. Mize. Thank you.

Mr. Ashley. Mr. Annunzio?

Mr. Annunzio. Thank you, Mr. Chairman.

Mr. Secretary, I would like to join my colleagues in commending you for your very constructive and practical statement before the committee on the problems that face us—the committee and the people of the country. I should also like to comment that as a member of this committee I have heard many witnesses—and I would like to use the analogy of the war in Vietnam—everybody wants peace, but they just do not know what to do about bringing peace to the world. But at least you came before the committee with a bill, a practical suggestion which indicates you recognize, like the members of this committee, that there is a problem in the money market, there is competition for money, and that in the public interest we must do something to stop this bidding in the money market among the various financial institutions that exist in the country.

Mr. Chairman, before I get into my questions, Mr. Rees, our colleague from California had to leave. He introduced a bill today regulating bank certificates of deposits and I would like to ask unanimous consent to include his press release in the record.

Mr. Ashley. At this point? Without objection, so ordered.

(The press release referred to follows:)

Legislation Regulating Bank Certificates of Deposit Introduced by Congressman Rees, May 19, 1966

Legislation restricting the use of bank certificates of deposit was today introduced by Congressman Thomas M. Rees, Democrat of Los Angeles, Calif., a member of the House Committee on Banking and Currency.

"It is my belief that the unregulated use of certificates of deposit is dangerous to the banking system of this country. Already overinvestment in certificates of deposit has caused serious problems of liquidity in banks throughout this country and, in some instances, has contributed to bank failures," said Rees.

"The unregulated use of CD's in driving interest rates up has caused a serious dislocation in the savings and loan industry. For example, in California bank certificates of deposit are being sold for amounts of even less than $100, for terms as short as 30 days, and at interest rates of up to 5½ percent. This has caused a flow of deposits from savings and loan institutions, which were held at 4.85 percent (prior to today's hike to 5 percent). The result has been a slowdown of both the building and real estate industries as new mortgage money is very difficult to find," continued the Congressman.

"If we do not develop reasonable restrictions on CD's, not only is the banking system dealing with an extremely dangerous situation in terms of liquidity, but it threatens the further development of fast-growing States such as California by denying necessary mortgage capital," stated Rees.

"The bill which I am introducing defines certificate of deposit as a deposit of 1 year or more maturity, which can draw an interest rate no more than the savings account interest rate authorized by the Federal Reserve Board. In this

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way the CD would be relegated to what its original intention was—to allow businesses to invest their excess funds in a time account for interest revenues," explained the Congressman.

"I believe this approach is far sounder than merely placing a floor on bank CD's," concluded Rees.

Rees hopes that his legislation on the subject of certificates of deposit can be heard during the current hearings by the House Committee on Banking and Currency.

Mr. ANNUNZIO. Mr. Fowler, Congressman Weltner sat on the committee for 4 years. I have been here 15 months and I have heard many, many comments from our chairman on the Federal Reserve Board. When I first came to Congress and sat in one of these meetings, in reading, I read about this Coordinating Committee that exists, with you as the Secretary of the Treasury and the Comptroller of the Currency and the Federal Reserve Board and the FDIC. I want you to know that I was a member of the cabinet of Governor Stevenson in the State of Illinois. As a member of that cabinet I had nine divisions under my jurisdiction but the chiefs of two of those divisions, the chief of the State factory inspectors and the chairman of the industrial commission, had their appointments approved by the Senate of Illinois and natural there was a conflict of policy matters because they felt that I had no jurisdiction until one day I discovered that if I did not sign the payroll sheet that the chief inspector and chairman of the industrial commission, along with their employees would not be paid. So one of the payroll periods came along and the director of labor just forgot to sign the payroll sheets. By that time the Governor and press and everybody else wanted to know about the problem that existed in the department of labor and soon I got the recognition that I was looking for. That seems to be the problem of the Coordinating Committee.

Again, I would like to emphasize that sometimes in these committees you wonder who watches us, and who coordinates the coordinator. So I agree wholeheartedly with the chairman of this committee that if the Coordinating Committee is to coordinate these various agencies having to do with monetary policy of the country, that direction should come from the President, the head of our Government. In this way understanding is established and the ground rules are laid, so that when one agency issues a directive, at least the other agency ought to have some knowledge of what is going on.

Mr. Fowler, on page 3 of your prepared statement you suggested all bank deposits cost the banks interest. But is it not true that approximately one-half of the bank deposits, the demand deposits, cost the banks nothing at all?

Secretary FOWLER. Demand deposits do not bear interest. I do not have the exact proportion, but it is about half. The banks have as the very basis of their being, so to speak, the function of intermediation—of taking the money that is on demand and using it against reserve requirements and to loan out the remainder.

Mr. ANNUNZIO. Mr. Secretary, my time has expired, but I would appreciate getting from your office a copy of former Secretary Dillon's report to which Mr. Minish referred.

Secretary FOWLER. Yes, sir.

Mr. ASHLEY. Mr. Ottinger?

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Mr. OTTINGER. Mr. Chairman, considering one of the bills that I introduced is subject to discussion, I wonder if we could not have unanimous consent to proceed sometime after the noon hour.

Mr. ASHLEY. I think we will continue within reasonable limits to accommodate the desires of the members. I do not intend to continue on too long after 12 noon.

Mr. OTTINGER. Mr. Secretary, I am very interested in the proposals you have made. I am somewhat concerned about areas of possible confusion.

First, I would like to have it made clear, that your proposal is that the Federal Reserve Board and the sometime complementary reaction of the FDIC would have, in effect, changed the power of regulation Q, bring down the interest rates on certificates of deposit on time deposits on denominations below the $10,000 present limit——

Secretary FOWLER. Also on the first $10,000 of any larger amount.

Mr. OTTINGER. Your proposal is not, on the contrary, that the savings and loan associations be permitted to increase the rates that they charge on their amounts—the question as far as your proposal is concerned does not involve the ability of the savings and loan associations to pay high rates?

Secretary FOWLER. No. It is a proposal, however, that takes into account the actions and policies of the Federal Home Loan Bank Board.

Mr. OTTINGER. There is a difference in the restrictions as they exist on Federal savings and loan associations, what they may charge on their accounts and the 4 percent that you referred to on page 4 as to the limit on passbook accounts?

Secretary FOWLER. Yes.

Mr. OTTINGER. The present limitation on what savings and loan institutions may pay is 4½ percent?

Secretary FOWLER. No, it varies around the country. It is somewhat on a regional basis. I think the announcement on Tuesday, for example, which was addressed to a particular situation, would allow savings and loan associations in California to continue to have access to advances for expansion if their annual dividend rates would not exceed 5 percent as of July 1, 1966, and are compounded not more frequently than quarterly.

Mr. OTTINGER. This I take it is a feature to which my colleague, Mr. Todd, was referring, that some of them are going to have a hard time taking advantage of that.

Secretary FOWLER. That is right.

Mr. OTTINGER. I would like to refer to a question by Mr. Gonzalez earlier, and that is, What is the sense of concentrating on these small certificates if indeed our problem is that 90 percent of them are in the larger denominations? It is my understanding that the volume is so great in these certificates of deposit now, some $17.5 billion, that even the 10 percent of the smaller denomination certificates are causing real problems for the mortgage market and that is really why we have to concentrate on the small certificates, even though they represent a small percentage overall.

Secretary FOWLER. I think that is true. It is the big ones which make up a lot of the volume but they do not really draw the deposits

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away from the typical savings and loan organizations and mutual savings banks.

Mr. OTTINGER. In my bill I pick $15,000 limit on the basis that we would eventually adopt the administration's proposal for increasing it.

Secretary FOWLER. I had that in mind, too.

Mr. OTTINGER. I hoped we might. But in setting the limitation, if it would become apparent through these hearings that we need to know more about where the savings and loan institutions lie, would it be possible for you or you in conjunction with the Federal Reserve people to work up figures for us showing for various denominations of certificates of deposit and how much money at the present time is invested?

Secretary FOWLER. I think that the information on that subject would best come from the surveys of the Federal Reserve Board. It has made one and I do not know whether the information requested would be wholly responsive to your question. We in Treasury do not have this information in the form in which you requested. I will do my best to see if we can get together the information that is available, either at the Federal Reserve Board or FDIC or other sources.

(The information referred to follows:)

Time certificates of deposit at insured commercial banks, Apr. 26, 1965, by size of certificate

[Amounts in thousands of dollars]

Size of certificate	*All banks*
$10,000 and under	10,217,617
Over $10,000 to $50,000	4,445,881
Over $50,000 to $100,000	2,290,200
Over $100,000 to $250,000	2,525,378
Over $250,000 to $500,000	2,966,921
Over $500,000 to $1,000,000	7,345,464
Over $1,000,000	6,250,630
Total certificates of deposit	36,041,850

Source: Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Federal Reserve Board.

Mr. OTTINGER. You recommend on page 8 that we consider raising the reserve requirements behind at least large denominations of certificates. Do you have legislation in mind or could you prepare something?

Secretary FOWLER. Well, I was really, in all modesty, expressing a preference for a particular approach and suggesting that if the committee moved in this particular direction, I think you would want to get much more information from the supervisory authorities.

Mr. OTTINGER. You recommend that we leave discretion to the Federal Reserve and FDIC in setting interest rates and limitations. It still seems to me that it is the Federal Reserve Board that got us into the problem that we are in now by permitting 5½ percent to be paid on certificates of deposit. I think that there are many of us who were not complacent about leaving that discretion in the Federal Reserve Board. I rather like your suggestion, however, that this is a temporary situation and perhaps we provide a temporary solution in terms of righting what we do in a period of a year or two years and take another look at them. Will you have any objection, if we placed a limitation of

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2 years to having a $10,000 or a $15,000—well, either interest rate mandated at that level or a floor placed such as my bill does—no certificates under the denomination of $15,000?

Secretary FOWLER. My own impression is that the movement here to mandate regulation is not a good practice or a good precedent for the Congress to undertake, and that the delegation of authority with fixing of standards for the exercise of that authority is a better avenue of approach. Conditions can change and do change very rapidly as we have found. It is better to make allowance for it. I would think that in this particular field, if the committee has very strong feelings and they want to assure, if they pass this law, that it is not going to lie unused, that you can effect that kind of understanding in the process of legislation, either formally or informally.

Mr. OTTINGER. Yet, you are willing to have us mandate interest rates, is that correct, the 5-percent interest rates?

Secretary FOWLER. No; I said that even in dealing with the interest rate matter, it is better not to mandate it into law. I think you are dealing with men who are sensitive to this situation and if there were very clear expressions of intent of Congress that this authority would not lie unused. This goes on in the legislative history.

Mr. OTTINGER. The Federal Reserve Board could have taken from that—the Federal Reserve Board could have taken some action to ameliorate its effect of regulation Q. It could have been directed specifically to some of the problems we have now if they had seen what was happening to the 5-percent rate and put it back. Maybe they could not have discriminated in their interpretation of the law between large and small denominations.

Secretary FOWLER. I think in all fairness to the Board, you have to recognize there is a certain chronology to this business. There were initial apprehensions and fears which I shared myself in December and asked the Coordinating Committee to study and look closely at the problem. They did in January. The Board sent out and made a survey of the changes in rates that were occurring early in the year. The returns from that survey did not indicate too much was happening, and then the situation took a much sharper, and much more acute turn, during the month of April and it has only been in the last 2 or 3 weeks that you and I and a lot of others have felt that some of our earlier apprehensions were now somewhat justified and that we ought to address ourselves very specifically and concretely to this problem.

Mr. OTTINGER. Just one more question, Mr. Secretary.

There is concern expressed in your statement that the chairman's overriding concern about your solution that you proposed or my solution, that we would be discriminating against the small investor in favor of the large investor. To what extent do you feel that this is a legitimate concern, or on the contrary, that it really reflects the increased purchasing power, if you will, of the larger institutions? Are we really doing anything to the small investor if we place a limitation on these certificates of deposit and the interest they may charge on the level at which they may be issued that is not already the case?

Secretary FOWLER. To me, it is a thoroughly warranted and justifiable action on several scores.

No. 1, at least in the context that I presented it, it is a temporary matter to deal with a transitional problem.

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No. 2, insofar as it can, the proposal is that each person gets the same rate on the first $10,000 and if the fellow can go more than that, then on the larger volume he would get a better return.

There is also an important element of risk attached to the larger amount. There is also the fact that there is in the law today in the way it operates a discrimination between the so-called passbook saver and the fellow who takes time, and has the knowledge and know-how, to take off from work and to go down to the bank to do what I am afraid I have not had the opportunity to do, and that is, to buy CD's.

Mr. TODD. Would the gentleman yield?

Mr. OTTINGER. Yes.

Mr. TODD. In this connection, Mr. Fowler, I wonder if my understanding is correct, in your draft bill, you would raise the passbook saving rate?

Secretary FOWLER. It would not affect that at all.

Mr. TODD. It would not affect it at all?

Secretary FOWLER. No, sir.

Mr. TODD. Thank you.

Mr. OTTINGER. Thank you, Mr. Secretary.

Mr. ASHLEY. Mr. Secretary, you were very generous with your time and the committee does appreciate it very much, the benefit of your counsel on this most important matter. If there are no further questions, the committee will stand in recess until next Tuesday morning at 10 o'clock.

(Whereupon at 12:10 p.m., the committee adjourned, to reconvene at 10 a.m., Tuesday, May 24, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

TUESDAY, MAY 24, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Ashley, Stephens, Gonzalez, Minish, Weltner, Grabowski, Gettys, Todd, Ottinger, McGrath, Annunzio, Rees, Mrs. Dwyer, Halpern, Talcott, and Mize.

The Chairman. The committee will come to order.

This morning, the committee continues public hearings on H.R. 14026 and related bills to eliminate misuse of certificates of deposit and time deposits generally.

Before we hear from today's witnesses who are five of the seven members of the Federal Reserve Board and two other high officials of the Federal Reserve System, I would like to make some preliminary remarks.

"It seems to me that the Federal Reserve has made a serious mistake over the past several years in repeatedly raising the interest rate ceiling on commercial bank time and savings deposits to the present very high limit. The arguments advanced in support of these increases—particularly the increase of December 1965—strike me as weak and even illogical. It does not seem consistent to act to restrain credit with one hand and to increase the flow of deposits into the commercial banking system with the other. The result has been to place competing savings institutions at a serious disadvantage, to bear down with unequal pressure on the housing market, and to set in motion a wasteful and possible dangerous scramble for deposits. It is not reassuring to have it explained that a rise in the rate ceiling was necessary in order to avert a money market crisis. Nor is it sensible to raise the ceiling and then criticize bankers for going to the ceiling. Both the theory and the practice of regulation Q are in need of some serious rethinking. It is to be hoped that the rethinking occurs before a point of no return is reached."

Interestingly enough, these few sentences I have just read did not originate with the chairman of this committee. They were spoken verbatim on April 13, 1966, by Mr. Gordon McKinley, vice president of McGraw-Hill, Inc., publishers of Business Week. Perhaps our witnesses this morning will address themselves to Mr. McKinley's

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charge and to convincing this committee why Congress should not itself prescribe specific guidelines with respect to time deposits.

The legislative history of the provision of the Banking Act of 1933 controlling high bidding for volatile deposits strongly suggests that the Federal Reserve Board has sadly fallen down on the job.

Before we hear the Board's side of it, let me quote from Senator Glass on the Senate floor back in 1933:

> We confide to the Federal Reserve Board authority which it does not now possess in this connection to regulate interest on time deposits in order to put a stop to the competition between banks in payment of interest, which frequently induces banks to pay excessive interest on time deposits and has many times over again brought banks into serious trouble.

Now it seems to me that last December's liquidity crisis facing banks in the large money centers due to possible withdrawal of \$3½ billion of corporate funds attracted in the first place by high rates on negotiable certificates of deposit is just what Mr. Glass was worried about.

Beginning in 1956, the Federal Reserve Board began successive amendments to regulation Q which the evidence indicates is the source of this problem. These changes have resulted in the present sky-high interest ceiling on time deposits—including CD's—and a minimum maturity of only 30 days on such deposits, which is ridiculous for a time deposit. These changes were made by the Board at the behest of a few large money market banks so that they could outbid Treasury bills for liquid balances of large corporations. In addition to the high rate and short maturity, negotiability was also a necessary feature. So while the Board argues it is helpless under the law to define time deposits in terms of minimum size, let there be no mistake that the Board does have the authority in terms of rates and maturities to stop the rate war which the Board itself started—the raiding of funds out of the Treasury bill market and the raiding of funds out of thrift institutions and home financing.

Unfortunately, due to the Board's inexcusable failure to make right a situation for which it alone appears responsible, Congress must take time out to legislate bank supervision which it mistakenly entrusted to the Federal Reserve Board. It is unthinkable that the same problem facing our banking system in 1907—illiquidity and unsound bidding for deposits—which led to establishment of the Federal Reserve System, still plagues us today.

Not for 1 minute should anyone think that the various bills now before this committee are intended to diminish competition for savings or to prohibit commercial banks from seeking time deposits on a sound basis. The large money centers seem to have spawned some purely banking problems which we expect today's witnesses to comment on in depth. Governor Robertson, in the course of your testimony, we would appreciate some discussion of your 1956 dissent in the Board's decision to raise regulation Q on December 3 of that year, which seems to have precisely predicted what has happened by constantly increasing interest rates.

Do you have that before you?

Mr. ROBERTSON. Yes, I do.

The CHAIRMAN. Would you mind reading that, if it is not too long, or commenting on it at this point?

Mr. ROBERTSON. Yes; I will proceed in any way you like, Mr. Chairman.

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The CHAIRMAN. If you will. I think it is so opportune and timely, and it occurs to me that you predicted in 1956, 10 years ago, what would happen.

Mr. ROBERTSON. You would like to have me read the dissent in 1956?

The CHAIRMAN. Yes, if you will, please.

STATEMENT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; PRESENTED BY J. L. ROBERTSON, VICE CHAIRMAN; CHARLES N. SHEPARDSON, MEMBER, GEORGE W. MITCHELL, MEMBER, SHERMAN J. MAISEL, MEMBER, AND ANDREW F. BRIMMER, MEMBER; CHARLES J. SCANLON, PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO; AND WILLIAM F. TREIBER, FIRST VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. ROBERTSON. This is taken, Mr. Chairman, from the Board's annual report. I have not read this in a long time, but I am sure it must be right. This says:

Governor Robertson voted against this action for the reasons set forth in the statement beginning on the following page.

A. An increase——

The CHAIRMAN. That was on December 3, 1956, if I remember correctly?

Mr. ROBERTSON. That is right.

A. An increase to 3 percent in the maximum interest rates that member banks may pay on (1) savings deposits and (2) time deposits not payable within 6 months would make it possible, it is alleged, for commercial banks to compete more effectively against other savings institutions for time deposits. Payment of such higher rates of interest might have these undesirable results:

(1) It would increase bank operating costs and make it more difficult for banks to raise additional capital that they need. Since any bank offering higher rates would have to pay them on existing as well as new deposits, net profits after taxes of some member banks could be reduced by as much as 25 percent—or more in the case of country banks—and this would lower net profits to below 6 percent of capital accounts, compared with an average of around 8 percent for many years.

(2) To offset such additional costs, banks would be under pressure to seek higher yielding assets, which would probably be less liquid and more risky, and thus impair the liquidity and solvency of the commercial banking system. Probably the principal purpose of the legislation authorizing regulation of interest rates on time deposits was to prevent such a development, which was to some extent responsible for the banking difficulties of the 1930's.

Furthermore, I have some doubts as to the effectiveness of such a raising of the interest ceiling in attracting savings to banks, because competing institutions could always pay higher rates. Their ability to pay more is due not to this limitation on banks but to other advantages with respect to such matters as taxation and restrictions as to the nature of assets that can be acquired. In addition, it is questionable whether generally higher rates on savings deposits would bring about a material increase in aggregate savings or would merely influence the form in which savings are held. It is plausibly argued that banks should be permitted to distribute to their customers as much of their earnings as they think they can afford, and that, since bank earnings are higher than they have been at times in the past, banks should be permitted to pay higher rates of interest on savings deposits. My answer is that Congress imposed on the Board the duty of preventing that very thing to the extent that it might jeopardize the soundness of the whole banking system. If the ceiling should be raised whenever a few banks feel they can afford to pay higher rates, there is no point in having a ceiling.

In view of these possible undesirable consequences to the commercial banking system, and my doubt concerning the effectiveness of such an increase, I would

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question the wisdom of raising the ceiling at this time and would vote to retain the present maximum rates. The number of banks which are now paying ceiling rates is small and only a fractional percentage of these banks actively seeks the privilege of paying higher rates. I would not accede to the wishes of those few banks and thereby, perhaps, adversely affect the whole banking system.

B. An increase in the maximum rate which can be paid by banks on time deposits payable in less than 6 months is questionable for a number of reasons:

1. Many of the funds thus held are not genuine savings but are liquid balances subject to withdrawal either to meet cash needs or to invest in other liquid assets whenever a rise in short-term market rates of interest makes such a shift profitable.

2. Banks would tend to treat such deposits the same as savings and determine their asset structure accordingly. This tendency is illustrated by the present situation in New York City banks which have substantial time deposits consisting of foreign central banks' balances and other liquid funds, such as trust department deposits, but have permitted their holdings of liquid assets to fall to exceptionally low levels. They now want to raise interest rates payable on such deposits to keep from losing them because they are so ill-prepared to meet the withdrawals.

3. Payment of high rates of interest on short-term time deposits would encourage evasion of a prohibition against the payment of interest on demand deposits.

4. Any resulting tendency to shift from demand to time deposits would reduce required reserves and thus release reserves for lending. This would not be in harmony with existing Federal Reserve credit restraint policies.

5. Liquid funds of this nature should be invested in open market paper, so that holders would have to bear the burden and risks of fluctuating rates and not shift that risk to the banking system.

Finally, it should be noted that if the ceilings are raised sufficiently to be effective, they will enable commercial banks to attract funds now invested in Government securities—short term and long term. This may have a detrimental effect on the Government securities market and even lead to higher levels of interest rates generally, as applied to the borrowing public. I doubt the need for, and prospective benefits of, a present change in the ceiling rates on time and savings deposits are such as to warrant risking this possible consequence.

Now, Mr. Chairman, that was written 10 years ago, and it sounds pretty good still.

The CHAIRMAN. Did it predict what would happen if these rates continue to increase?

Mr. ROBERTSON. I think this is true, but I am sure some of my associates would not concur in these views.

I would add for myself that notwithstanding the impressiveness of those views, the ceilings have been raised a number of times in the interim, and as a result we have not only that dissent, but we have other dissents as we know the record discloses. But we now have a situation in which the rules have been built into the pattern of competition in this country, and consequently you simply cannot back up to the situation which existed 10 years ago without very destructive consequences.

I would suggest perhaps the way to link this to the present subject of the hearings would be if I were to proceed with the statement which I will read in behalf of the Board, and then perhaps the committee would like to interrogate all the members.

The CHAIRMAN. That will be satisfactory. You may proceed, sir.

Mr. ROBERTSON. It is my purpose today to express the views of the Board of Governors on the two bills—H.R. 14026 and H.R. 14422—that are the subject of these hearings. It might be helpful to begin with a summary of recent developments in banking, attempting to place those developments in historical perspective.

As this committee is well aware, the commercial banking system has become more active in recent years in seeking longer term savings

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funds. This has not been an isolated phenomenon, but rather an integral part of a major change in the character of commercial banking. Banks have become increasingly ready to challenge traditional or outmoded practices. They have become more aggressive not only with respect to bidding for deposits, but also in finding ways to put funds to profitable uses, in opening new facilities, in providing new services for bank customers, and in reducing costs by adopting more efficient techniques of production, especially through automation.

In addition, the increased activity of banks in bidding for time deposits appears to reflect a response to the declining trend of bank liquidity over the postwar years. Under the conditions of high liquidity and limited loan demand that prevailed from the mid-1930's through the early years of the postwar period, banks showed little interest in competing for time and savings deposits. As loan-to-deposit ratios advanced over the postwar years, banks came to be increasingly concerned about their ability to meet their customers' loan demands. This concern increased in late 1959, when soaring credit demands and monetary restraint put many banks under pressure.

Shortly thereafter, banks increased their efforts to attract time and savings deposits, especially for corporate time deposits through the issuance of negotiable certificates of deposit. The emergence of the negotiable certificate as a money market instrument began in early 1961, when a large New York City bank announced that it would issue certificates of this kind to both corporate and noncorporate customers and that a large Government security dealer was establishing a secondary market for those instruments. Since 1961, outstanding negotiable certificates in denominations of $100,000 or more—certificates large enough to be traded readily in the secondary market—have increased to more than $17 billion. Growth in outstandings has been relatively slow since the fall of 1965, however, and it may be that the period of rapid growth of these deposits is largely behind us.

If I may divert your attention for just a moment, Mr. Chairman, you will note on your chart, on the right-hand side, the growth in 1965 was sharp, but that sharpness was accentuated by growth in the first three quarters, with a slowing off in the last quarter which has proceeded during this year.

The CHAIRMAN. Just a moment.

Mr. REUSS. A short question on that point. The chart there—my old eyes have difficulty. Is that December 1, 1965?

Mr. ROBERTSON. December 1, 1965.

Mr. REUSS. Well, I am under the impression that negotiable CD's have increased another billion dollars to about——

Mr. ROBERTSON. Up to about $17 billion.

Mr. REUSS. $17½ billion, isn't it, to date?

Mr. ROBERTSON. I cannot give you the exact figure, but somewhere in that area—17.6.

Mr. REUSS. I would like to see a projection, because I, frankly, am a little skeptical about this notion that all is now peaceful.

Mr. ROBERTSON. No——

Mr. REUSS. And the negotiable certificates of deposit are not going up. I am under the impression they have gone up——

The CHAIRMAN. We prepared the charts.

Mr. REUSS. It is our chart?

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The CHAIRMAN. And we will extend it in view of your request.

Mr. REUSS. Before the hearing is over, I would like to have an accurate estimate of where they have gone since then.

Mr. TALCOTT. Can you change the chart at someone's request?

Mr. ROBERTSON. I will furnish all the information desirable.

Mr. REUSS. I am told that, as of May 11, there were $17,571 million of negotiable time CD's outstanding.

Mr. ROBERTSON. Right.

Mr. REUSS. That, to me, indicates no slacking off of the upward curve.

Mr. MITCHELL. May I?

Mr. ROBERTSON. Yes, sir.

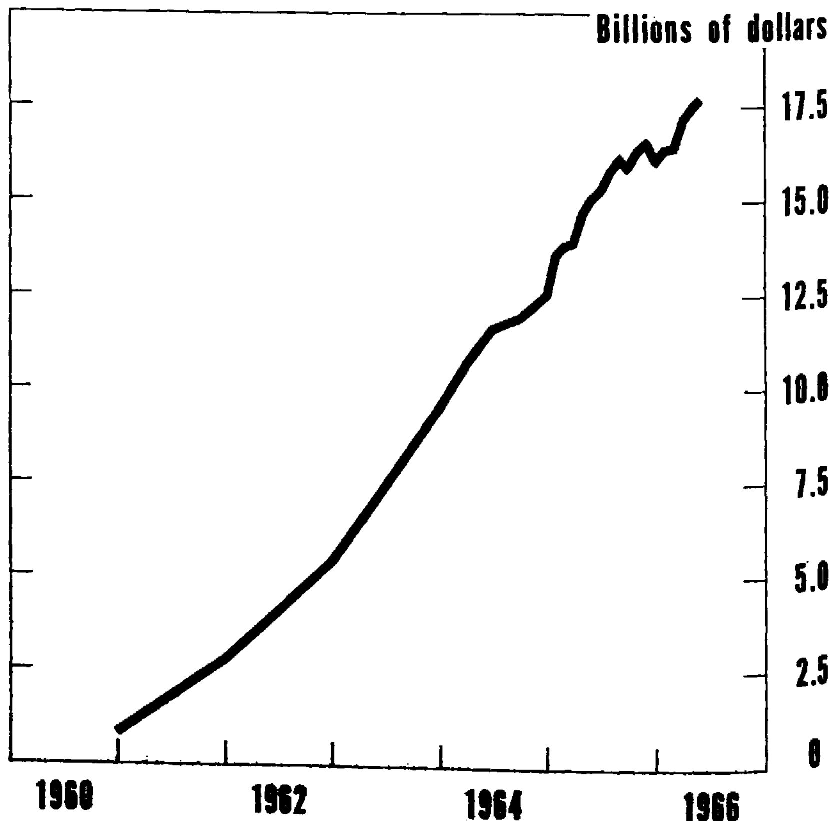
Mr. MITCHELL. It reached about 16.3 or 0.3, in the summer of 1965, but it did not change again until just recently, when it went up into the 17½ range. It was flat for a period of about 6 months.

The CHAIRMAN. May I suggest, Governor Robertson, that you prepare a new chart and bring it right up to date and we will insert it in the record at this point.

Mr. ROBERTSON. We will be very glad to do that, sir.

(The information requested follows:)

NEGOTIABLE CD's



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Outstanding negotiable time certificates of deposit[1] at weekly reporting member banks on selected dates[2]

	In millions of dollars
Dec. 31, 1960	796
Dec. 30, 1961	2,782
Dec. 5, 1962	5,442
Dec. 31, 1963	9,579
1964:	
Mar. 25	10,718
June 24	11,687
Sept. 30	11,955
Dec. 30	12,583
1965:	
Jan. 27	13,633
Feb. 24	13,866
Mar. 31	13,962
Apr. 28	14,741
May 26	15,110
June 30	15,342
July 28	15,840
Aug. 25	16,177
Sept. 29	15,917
Oct. 27	16,387
Nov. 24	16,610
Dec. 29	16,097
1966:	
Jan. 26	16,430
Feb. 23	16,483
Mar. 30	17,193
Apr. 27	17,502
May 18[3]	17,743

[1] Denominations of $100,000 or greater.
[2] Figures for 1960–62 are estimates.
[3] Most recent date for which data are available.

Mr. ROBERTSON. Pressure on banks to find lendable funds has intensified since 1961, as loan demands of customers have continued to outstrip the growth of deposits. Consequently, banks have become increasingly alert to the possibilities of tapping new sources of funds, especially through issuance of negotiable and nonnegotiable certificates of deposit in smaller denominations, often called "savings certificates" or "savings bonds."

The two bills before the committee would cut off commercial banks from important sources of funds through which they have been able to meet the rising financing needs of businesses, consumers, home buyers, and State and local governments. They would also prohibit banking practices of long standing. The earliest data available showing a detailed classification of time and savings deposits by type indicate that, in 1928, time certificates and open account time deposits comprised about one-fourth of all member bank time and savings deposits held by businesses and individuals. This is nearly as high as the current proportion. The issuance of certificates of deposit to small savers has been a common practice in some Midwestern and Southwestern States for many years. In 1928, country banks in the St. Louis and Kansas City Federal Reserve Districts held as large an amount of savings under time certificates of deposit as in savings accounts, suggesting that in those districts, small-denomination time certificates were a leading channel for the placement of individual savings. Our most recent survey confirms that certificates of deposit

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in small denominations are still an important source of funds to small banks in the Midwest and the Southwest.

I might say that in my hometown of Broken Bow, Nebr., they still use time certificates instead of savings deposits as a general rule.

The CHAIRMAN. For your area or the whole country?

Mr. ROBERTSON. No, no; just for Broken Bow only.

The CHAIRMAN. That's good; just your area.

Mr. ROBERTSON. My area.

The negotiability feature of certificates of deposit also has substantial legal precedent. The language used by many banks in their certificates is patterned after wording used in four examples published by the Board in 1933, to provide guidance to member banks in drawing up time certificate contracts that would be consistent with Federal Reserve regulation Q. The suggested language was widely adopted, and many banks presently issue certificates of deposit that are legally negotiable, even though little use is made of the negotiability features. Many of these certificates are in small denominations and are issued by small banks, even though the largest part of the dollar volume of negotiable certificates consists of certificates issued by large banks with denominations in excess of $100,000. Thus, a recent Federal Reserve survey indicated that three-fourths of the number of member banks with negotiable certificates of deposit outstanding to individuals and businesses on December 22, 1965, were banks with less than $50 million in total deposits.

The changed attitude of banks toward bidding for time deposits, together with the increases in maximum rates payable on time and savings deposits under regulation Q, has altered signficantly the role of the commercial banks as an intermediary channeling funds from savers to borrowers. The proportion of total credit flows financed by expansion of commercial bank deposits has been considerably higher in recent years than in most postwar years. This increase in the financing of economic expansion through the banking system has been accompanied by some decline in the relative position of the banks' major institutional competitors in the savings field, although the absolute size of these nonbank intermediaries has continued to increase rapidly. Most recently, particularly in the period since year-end, the growth rate of all financial institutions has slowed, as more savings have tended to flow directly from savers to borrowers rather than through financial intermediaries, reversing the pattern of savings flows that had persisted over the expansion of the previous 5 years.

With this background information in mind, let us turn now to more specific consideration of H.R. 14026 and H.R. 14422. There is every reason for Congress and the supervisory authorities to remain alert during periods of structural change in financial flows such as those now in process. There is always a possibility that changes in the competitive position of financial institutions may be accompanied by excessively zealous efforts to gain a short-run advantage, and to actions that might raise questions about the liquidity, solvency, and viability of financial institutions. In contemplating the need for supervisory or legislative action, however, it must be borne in mind that the forces of competition have great potential for promoting the interests of the consumer and for serving the public interest.

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The two bills at issue represent, in the Board's judgment, efforts to circumscribe competitive processes in ways that are harmful to the public interest. H.R. 14026 would prohibit issuance of negotiable certificates of deposit and other similar negotiable instruments purely on the grounds of their negotiability. We can see no justification for a general prohibition of that kind. The legal status of the negotiability feature of time certificates has a longstanding historical precedent. On economic grounds, the attribute of negotiability does not, in and of itself, impair the liquidity of the issuing bank nor of the banking system as a whole. The ability of the holder to sell these certificates in secondary markets increases the attractiveness of the instrument. Because the certificates bear stated maturities, bank portfolio managers are in a position to adapt the maturity structure of their assets to the scheduled maturities of their deposit liabilities. The emergence of new financial instruments, and the adjustments in financial markets that take place because of them, have to be taken into consideration in the formation of monetary policy. But the mere presence or absence of negotiability does not impair the ability of the monetary authorities to implement whatever policy is called for by the economic situation.

H.R. 14422 would prohibit insured banks from accepting time deposits in denominations of less than $15,000. It would deny to banks the use of an instrument employed for many years in attracting savings of individuals. It would deny to the small saver a form of bank deposit to which he has been accustomed, but it would not prohibit the issuance of certificates of deposit in large denominations to individuals of substantial wealth or to businesses. Under the present structure of ceiling rates, small savers would obtain at most the maximum rate payable on passbook savings—4 percent. Those fortunate enough to be large depositors could earn as much as 5½ percent. Such differential treatment of large and small savers on the basis of deposit size alone would be discriminatory.

The Federal Reserve Act now specifies four criteria the Board may use in setting the maximum rates payable on time and savings deposits: maturity of deposit, conditions respecting withdrawal or repayment, bank location, and the discount rates in the several Federal Reserve districts. It has been suggested by the Secretary of the Treasury that the act be amended to give the Board temporary authority to use an additional criterion for differentiating maximum permissible rates, namely, the extent to which a time deposit is afforded protection through insurance by the Federal Deposit Insurance Corporation. The rationale underlying this proposal is that returns on investment should be scaled according to the risk assumed by the investor. Accordingly, because a depositor's risk on the insured portion of the deposit is eliminated by the assumption of a contingent liability by the Federal Government, the maximum rate payable on that portion could be less than on the uninsured portion.

The Board welcomes consideration of measures aimed at increased flexibility in administering ceiling rates on time and savings deposits. But experience has taught us that this is a complicated field in which changes sometimes produce ramifications that are not anticipated. For this reason, the implications of a new legislative proposal should be thoroughly explored by Congress, and new powers should be exer-

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cised by regulatory agencies only after careful exploration of ultimate as well as immediate effects.

For example, in administering the proposed amendment, it may well prove difficult to achieve at one and the same time its stated objectives and equitable treatment as between small and large depositors. However, we wish to assure you that if the suggested amendment is enacted into law, the Board will conscientiously assume the responsibility for its use, in conjunction with its existing authority to regulate interest payments and its other policy instruments, as the public interest requires.

The amendment also raises questions concerning the principle of equity among competing financial institutions. Consequently, Congress might wish to consider whether parallel legislation is needed to authorize the application of a similar criterion with respect to rates of interest on federally insured deposits or shares at other savings institutions.

Changes in the competitive situation among financial intermediaries merit continuing close surveillance. The Board is watching developments closely for any indications that these competitive developments might be taking forms that are harmful to the public interest. The Board has ordered a new survey—which is now in the field—of changes since early 1966 in the rates banks are paying on various classes of time and savings deposits, and in the net flows of these deposits during this period. If regulatory actions seem to be needed, in the light of unfolding developments, the Board will not hesitate to take whatever action is called for. It also will not hesitate to request new legislative authority if this should seem necessary or desirable.

Now, Mr. Chairman, I would be very glad to attempt to answer any questions, but I know my associates will want to express additional views, at times differing from mine.

The CHAIRMAN. We will feel free to interrogate each one of them.

Governor, we appreciate your statement and it gives us a lot of information which we will need, and it certainly will receive careful consideration.

It comes from the Board, as I understand?

Mr. ROBERTSON. It does.

The CHAIRMAN. As well as from yourself?

Mr. ROBERTSON. Yes, sir.

The CHAIRMAN. The main question before us right now, Governor Robertson, is the increase of the rate of 4½ percent to 5½ percent, December 6. Naturally, that has caused a lot of trouble. Now, do you feel that the Board should give consideration to lowering that rate at this time, Governor Robertson?

Mr. ROBERTSON. As you know, my feeling in December was that this was not the appropriate action and that dissent is a matter of public record.

However, I feel that, now that the competitive situation has developed, in the light of those actions, that we should be very careful in seeing what the problem is and then gearing our action to the problem, but that we should take action in correcting any development that would be adverse to the public interest.

I would think that, in order to do that, we would want to be very sure that we know what we are doing, when we are doing it, and that

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it is timed right. This can be done as soon as our survey is completed, which should be by the middle of June. We should then be in a position to determine the nature of the problem and tailor the remedy to suit it.

The CHAIRMAN. Now, you state here that although you do not favor the suggestion of limiting the amount of, say, under $10,000, you get 4 percent, and above $10,000, 5½ percent, and I share your views on that. I think it is discriminatory. I do not think the Members of Congress will vote for it, not on the floor of the House, because I have never known Members to vote to discriminate against the poor in favor of the rich.

For that reason, I do not think they will do it.

You state that although you are against it, you will, of course, if Congress enacts it into law, carry out your responsibility, which, as I understand the law, you are charged to do.

Mr. ROBERTSON. That is our job.

The CHAIRMAN. And you do not mind doing it.

Now, if Congress does not get what it wants from the Board of Governors—there is lots of feeling all over the Nation about this thing; there is lots of feeling for other financial institutions, not because they are savings and loans, credit unions, mutual savings plans, but because of what this adverse action is doing to the homebuilding industry and thrift institutions all over the country. They feel that unfair advantage has been taken of them and that advantage is cutting to the heart in lots of places in this country, and the people are very strongly against it and are demanding that their Members of Congress do something about—demanding of them that something be done about it.

It is discrimination at its worst, from the standpoint of many of our correspondents and many of our constituents. So, do not be surprised if Congress should assume its duty of trying to do something about this, either by law, or, I guess, a joint resolution would be sufficient. If Congress passed a joint resolution telling the Board that we want you to put the interest rate at 4½ percent, you would have to do that; would you not?

Mr. ROBERTSON. I am sure we would be obliged to do it.

The CHAIRMAN. And a lot of us feel like this 4½ percent would really solve this question.

If you reduce that 5½ to 4½, all financial institutions could live and really have healthy and wholesome competition. We hope you will give consideration to it, Governor Robertson, because the situation right now is critical.

The reason the people feel strongly about this is, back in 1932, under Mr. Hoover, a Republican administration, there was a lot of feeling of dissatisfaction, because the banks had not had any feeling about homebuilding and would not help out in the homebuilding market, and Mr. Hoover initiated, of course, the Federal Home Loan Bank System, and got the Federal savings and loans started, because the banks would not do it. They just would not do it, because they were not interested in it.

Now, after all this period of time, this $130 billion financial industry has been built up, savings and loans, and has built more homes

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than have ever been built in America. Without savings and loans, we would not have our fine homes over the Nation, or as many.

You realize that, don't you, Governor Robertson?

Mr. ROBERTSON. Very much so.

The CHAIRMAN. Therefore, we should not do anything so drastic and arbitrary as to punish those very institutions that really saved our country, because shelter is about one of the most important things we have for family life in this country, and we must encourage things like that. And that is the reason there is so much resentment now against it that seems to hit the institutions the hardest that have done so much for us in the last 30 years in the way of building homes, decent homes, for people to live in.

The feeling of Members, I think you will find, is very strong in that direction, and it is possible they might get impatient with the Federal Reserve Board if something is not done to change it, and I just hope that the Board will give consideration to that and not even wait until June, or if the situation begins to worsen, as it seems to be right now.

It is just intolerable, we just cannot put up with it.

Anyway, you pledge that the Board will give consideration in these changing times, to the changing situations. But it is real urgent, Governor Robertson. It is pressing down on the people right now, and we might be thrown into, or be on the verge of a real depression, and we do not need any depression right now.

Mr. ROBERTSON. I would like to say, Mr. Chairman, we are very alert to this, and we are not waiting on statistics. We are actively endeavoring to find out what the actual picture is, in order that we can decide whether we will have means at our disposal to improve the situation.

As of this moment, there is some doubt as to whether the problem is as real as some people think. It is a problem; there is no question about it, but the flow of funds from one kind of institution to another kind of institution seems to have tapered off to some extent. There are spotty situations, of course, but a lot of the problem at the moment I might say, in my own view, is based on fear of what is likely to happen rather than on any present situation, but this is something that we are watching verv carefully.

The CHAIRMAN. This 1965 action, on December 6, put the rates up 37½ percent. Suppose automobile manufacturers increased their prices that much or labor had attempted to increase their wage rates that much—or anybody else—people would scream to the high heavens, and they could not take it at all. But here, the monetary authorities come along and at one stroke of the pen just increase interest rates 37½ percent. I occurs to me that real consideration should be given to that part of your order immediately.

Do you have in mind any immediate sessions of your Board?

Mr. ROBERTSON. This subject is raised at practically every session of our Board in some form or another.

The CHAIRMAN. Mrs. Sullivan?

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Governor, in the testimony before this same committee last Thursday, May 19, Secretary of the Treasury Fowler stated that negotiable CD's served as a liquid money market instrument rather than as a

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savings medium. What are the dangers to commercial banks of their bidding up high for huge funds which are essentially liquid, interest-bearing deposits rather than bona fide bank deposits received in the normal course of business?

Mr. ROBERTSON. Well, the dangers, of course, from my own personal point of view—and I may say that I am perhaps more interested than most people in the question from a supervisory point of view, because of background in this field—my main concern about the whole CD field goes to the point of liquidity of the banks themselves.

Now, it is perfectly possible for banks to use time certificates of deposit to obtain funds safely.

It depends entirely upon what they put those funds into, but if they put those funds into long-term obligations, and you have withdrawals because of interest patterns going up, and you can't roll those over, they have insufficient liquidity with which to meet those withdrawals. This constitutes a very real danger and I think is one of the things which have to be watched very closely. This is one of the reasons that I have pressed over the years for much more effective bank supervision than we have, and unified Federal supervision.

But, we do not have that sort of thing. We do need, it seems to me, to develop as a matter of governmental policy, much better bank supervision than we have, one that is concentrated on the problem from the point of view of safety, liquidity, solvency, and viability of the institutions.

Mrs. SULLIVAN. Governor, why does the Federal Reserve System permit this situation to persist after really having created it by increasing the interest rate?

Mr. ROBERTSON. I must let other members, my associates, speak on this subject, but I am sure that they feel and deeply feel that this is being handled in a safe manner by the banking institutions of this country, that they are in a position to maintain appropriate liquidity and enable them to meet these withdrawals.

From my point of view, there has been an attitude developed over the years whereby banks have come to believe that whenever interest rates are pushed up to the ceilings, we will automatically raise those ceilings. This is a false premise, because I do not think this Board or any other board will permit banks to pay higher rates to attract funds unless they are convinced that banks are handling this in a safe and sound manner. This is a matter of judgment.

Mrs. SULLIVAN. Would any of the other of your associates care to express an opinion?

Mr. ROBERTSON. I am sure they would.

Mrs. SULLIVAN. Mr. Maisel?

Mr. MAISEL. Mrs. Congresswoman, I think the fair thing to say here is that we are concerned with the efficiency of our monetary and credit system. My own attitude in December was, first, that we would have been better off delaying the use of monetary policy at that time in the hope of getting fiscal action, and second, having decided to use monetary restraint, that we would have been better off using open market operations rather than causing rates to go up through a discount change, but having done it, I do not think that we had much choice. The present situation results simply from saying: "If we do not allow banks and other financial institutions to compete with the money mar-

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ket, they simply are not going to have the money to lend to their customers." I think this is the question we are concerned here with—intermediation, and how our banking system operates.

I disagree with the earlier statement of Governor Robertson, I think his dissent was wrong. My own feeling is that a mistake was made by putting price ceilings through regulation Q on the amount that banks could pay from the period of 1957 through 1963. As a result of that action we had the normal results of any price ceiling. Funds flowed too far into the wrong areas. As a result, while savings and loans did a very good job, toward the end of that period they had more money coming in than they knew what to do with. The ways in which they used this money was rather inefficient for the economy. Less and less of their money was going into the single-family house market. More and more was going into other types of use.

The concentration of funds in savings and loans tended to flow into certain States. All of this, I think, was a result of the Q ceiling which was maintained too long by the Federal Reserve. The restriction on the amount that banks could pay was too great.

Now, I think this has increased the problem we face. We must decide whether we believe in the market setting rates. Do we believe that savings should flow where the market feels they will be used most efficiently?

My own belief is that there is a danger in competition, just as there is a danger in any market. However, for the present, until we see how great the danger is, and where we are going, we ought not to make the mistake that we made before. We should not create additional problems by using ceilings. Interest-rate ceilings are like wage ceilings or price ceilings, or any other sort. There are times when they are useful.

On the other hand, historically, the way we try to run our economy is to let the market determine what the most efficient use of resources is. We did not do this, so that part of what we are seeing now is a correction of a prior maldistribution of funds. Certain institutions which went way out of line and got too many funds compared to what they could use efficiently are now suffering slightly. But since we believe in a free-market economy, I think that, at least for the time being, we ought to let the market distribute the funds the way it can most efficiently.

Mrs. Sullivan. Thank you, Mr. Maisel.

My time has expired.

The Chairman. Mrs. Dwyer?

Mrs. Dwyer. No questions.

The Chairman. Mr. Reuss?

Mr. Reuss. Thank you, Mr. Chairman.

First, Governor Robertson, let me take this opportunity, irrelevant to the hearing this morning, to congratulate you on this splendid job you are doing with respect to our balance of payments and foreign bank loans.

Mr. Robertson. Thank you very much.

Mr. Reuss. I think you, and your colleagues, ought to be congratulated for providing one of the relatively few bright hopeful brush strokes on our balance-of-payments painting.

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Now, on the subject on which I do not feel as chummy, certificates of deposit, let me recapitulate my views on this monster which I presented last December before the Joint Economic Committee, when you and your colleagues were present.

It seems to me that in allowing certificates of deposit to go up in 5 years from zero to more than $17½ billion, the Federal Reserve System has allowed the Old Man of the Sea to get on its shoulders and ride it. I am impressed by the fact that to the extent that the certificates of deposit have abstracted money from our savings and loan associations, it has had the effect of transferring credit from the homebuilding industry, where there is now a 9.9-percent unemployment rate, where more economic activity could be accomplished without inflation, it has transferred large parts of this to bank inventory loans, which have a very inflationary effect.

In your statement, Governor Robertson, you refer on page 4 to the marked increase in credit flows through the commercial banking system, and "This increase in the financing of economic expansion"— that is how you refer to it.

Now, I really question that philosophy of the Federal Reserve. I do not think that automatically more credit in the Federal Reserve means economic expansion. Some of it may mean inflation. And to the extent that bank loans, particularly by the big 30—New York-Chicago banks which hold the bulk of these $17½ billion of certificates of deposit—I have reason to believe that some of their lending practices are in order to build up inventories in business in excess of that which is needed.

My objection to the uncontrolled negotiable time certificate of deposit regime we now have is, first, that it diverts credit from those sections of the economy which could lend it in a noninflationary manner, as to the housing industry, to financial institutions, by big banks which lend in part at least in an inflationary manner.

Second, I object to the discrimination in our banking system which allows the 30 big banks which, having built up a secondary market and having a good opportunity to market the certificates say at 5½ percent, I object to the discrimination in their favor and at the expense of the other 13,000 banks, not to mention all the other financial intermediaries.

Third, I object because, since the Federal Reserve now has only a 4-percent reserve requirement on negotiable certificates of deposit, it seems to me you therefore lose some control which you ought to have over the total credit capacity of our banking system and thus either have to tighten money inordinately over the whole system and squeeze the other 13,000 banks in order to control the 30, or, more probably, you have to loosen the credit-creating capacity of the entire system in order to not squeeze out the 13,000 banks which are not importantly in the time certificate of deposit business.

I would like, therefore, for you and your colleagues to comment upon my indictment, if you want to call it that, and specifically to ask your views on the Reuss proposal which I have been making ever since December, which is that the Federal Reserve ought to increase the reserve requirement on negotiable certificates of deposit, which it could do tomorrow, from 4 to 6 percent—and more than that—that it ought to have power from Congress to increase those reserve require-

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ments on negotiable certificates of deposit within its discretion up to a level of perhaps equal to that required for demand deposits.

Would you comment on the package?

Mr. ROBERTSON. If I could comment, first, I am sure some of my associates would enjoy debating this issue.

I hesitate to say too much, because I am in sympathy with this point of view. There may be differences between us in some areas, but in general I have great sympathy with this point of view.

I think that insofar as the drains from the savings and loans are concerned, they are not due to the big CD. It is the gimmick instrument—the savings certificate or savings bond at a higher rate of interest—which has been pulling funds out of the savings and loans and, therefore, from that point of view any changes should be directed to that field instead of the other.

I do however realize that the impact of monetary policy in a time when you are having a tight policy ought to be evenly distributed over the economy, as evenly as possible. It is intended to have a bite, but you don't want to take the whole bite in one area and no bite in another.

Furthermore, there are areas where the inflationary impact of loans is particularly great. For example, in plant and equipment expansion, the machine tool industry is probably the tighest area and is the greatest bottleneck in the whole field, and to the extent that loans are made in that area, you are merely adding to the demand for the inadequate supplies. Therefore, I think it is unfortunate that at the present time you are having a bigger impact on the building industry than you are in other areas.

With respect to the reserve requirements, I happen to believe that this is a time when we should be raising reserve requirements on time certificates to the extent we have power, and I would welcome, personally, a more flexible, a wider spread power to fix reserve requirements on time deposits, because, in my opinion, time deposits are much nearer to being a part of the money supply today than they were 10 years ago.

At that time, you could argue with great certainty, I think, that they really were not, that all you had to do was control the demand deposits. I no longer believe this. I believe that time deposits are coming closer and closer to being a part of the money supply.

Now, with those comments, let me suggest that you get your response, and that is what you want, from either Governor Mitchell or Governor Maisel or Governor Brimmer.

Mr. REUSS. I do intend to get it from each one of your colleagues. I note that my first go-around time is up, but I do have time for a comment, and a question, which is: From what you have just said, Governor Robertson, it does appear that you agree with me, and since you are a member with the right to vote on the Fed, and since the Fed is not doing what you and I think should be done, it is going to be my business from this day forward to see that the Fed is directed and required to do that which you and I hope some of your colleagues want to do but are evidently prevented by being out-voted from now doing. That is all.

The CHAIRMAN. Mr. Ashley?

Mr. ASHLEY. Governor Robertson, from the testimony you have presented, I take it that the Federal Reserve Board not only objects to the legislation under consideration but has no recommendation for any legislation in that area, at all; is that correct, sir?

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Mr. ROBERTSON. That would be my personal view, simply because I happen to think that we have ample powers within existing legislation to cope with any foreseeable problem in the immediate future.

I see no problem arising which we are not in position to cope with.

Mr. ASHLEY. Do you see any problem which needs some action directed to it?

Mr. ROBERTSON. I see a problem which may be coming up, and soon we will have better information to judge whether we can correct it. We might return, for example, to a schedule with rates adjusted to maturities, so that a depositor could earn a higher return only by giving up, for a longer span his right to withdraw his money.

There are many ways in which this problem can be dealt with, but I would say that as of this very moment, I would not advocate any particular change. I would want to see the way in which the problem unfolds before acting; but we must act promptly once we have identified a problem we can help to solve.

Mr. ASHLEY. Well, now, it is pretty well known that savings and loans are, in most parts of the country if they are making any loans at all, requiring a third down, and also that the loan be less than 10 years old. Is this a situation that is confronting them, just the outgrowth of kind of a normal increase in demand for credit, Governor?

Or is this a rather unique situation that is caused by a unique problem to which there should be some kind of attention directed and, presumably, a solution found?

Mr. ROBERTSON. Attention is being directed to this problem. The problem is that in some areas of the country, savings and loans have suffered a loss of savings accounts, but so have all financial institutions in the immediate past. There has not been the growth in savings there was before, because of the flow directly from savers to the markets. However, they fear that if there is another increase in the rate structure, the flow to them will be diminished greatly, and as a result they are not making forward commitments.

There has also been a tendency, I understand, on the part of borrowers, to speed up the use of outstanding commitments in order to take advantage of lower rates, and this is adding to the difficulties that savings and loan associations face at the present time. But they fear a greater outflow, more than they can sustain, because of their very low liquidity position, and this is not a problem which has just come to the fore now; this is a problem which has been developing over the years.

But this is not a problem we are not aware of; we are aware of it.

Mr. ASHLEY. With the change in regulation Q, hasn't this put increased pressure on savings and loans and similar institutions to respond in kind as best they can?

Does this put pressure on them to seek means by which to pay their depositors more?

Mr. ROBERTSON. Oh, yes; absolutely.

Mr. ASHLEY. And just put continued pressure on higher interest rates?

Mr. ROBERTSON. Oh, no question about the fact that there has been greater pressure on them. They are going to have to pay more in order to get the funds with which to make their loans. This is merely a part of the process, the competitive process.

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Mr. ASHLEY. But they are responding to a situation brought about by the Federal Reserve Board; is this not so?

Mr. ROBERTSON. This is a situation which is brought about by a tighter monetary policy which, in turn, is designed to curb demand, in order that we do not have an excessive volume of money chasing an inadequate supply of goods and services, so you have the situation——

Mr. ASHLEY. It seems to me that banks have enjoyed, however, a very favorable competitive situation as against the savings and loans.

I can understand the necessity for a tight money policy upon occasion, but I do not believe, as I understand it, Governor, that this has been brought about in a manner that treats equally and fairly institutions' differing characters. Of course, the commercial banks, I believe, have been favored over the savings and loans, from the evidence that has been presented to me. This is certainly the conclusion I would have to reach.

Mr. ROBERTSON. I think you ought to be careful about that, because over the years one kind of savings institution has had no ceilings over it at all, whereas the banks have had. And, for many years, the savings institutions did have a competitive advantage over banks.

Now, unfortunately, this particular increase was so abrupt and so great that it changed that competitive pattern too abruptly and did create that problem you are talking about. No question about that in my opinion. But it is a problem which you just do not turn back immediately, because patterns become established.

Mr. ASHLEY. Violent actions often do beget violent reactions, and this is why we are here today.

Mr. ROBERTSON. That is right.

Mr. ASHLEY. Because of the violence of that action.

Mr. ROBERTSON. This is right, but I merely urge you to be careful in knowing exactly what your problem is.

Mr. ASHLEY. You urge me to be careful, but you do not choose to exercise that care yourself.

Mr. ROBERTSON. I would like to say we are trying to be as careful as we can, Mr. Congressman.

Mr. ASHLEY. That is after the fact somewhat, is it not?

Mr. MAISEL. May I speak, Mr. Congressman?

Mr. ASHLEY. Of course.

Mr. MAISEL. I think that you are calling attention to something which has been well known. This situation is not a particularly different situation than at any other time when monetary restraint has come into the economy. This is a normal cost of using monetary policy.

I think what you are objecting to—and I think this is a point that has to be made clearly—is the high cost, in a particular sector and particularly in the area that we are talking about, housing, of the use of monetary policy. If the Congress believes that monetary policy should not be used because it is costly in specific areas, then this is a proper basis upon which to make its decision. I certainly have always called attention to this fact.

This is why, in my own view, fiscal policy, such as an increase in taxes or doing away with the investment credit, would have been a better policy for this period. But I think, having failed to use fiscal policy in December or January, having required that monetary

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policy be used to attempt to curtail the excessive demand and for balance-of-payments reasons as well, then I think it is not surprising that the use of monetary policy costs particular sectors a great deal. This is what we know about the use of monetary policy, that it has to pinch in the mortgage market and other specific sectors.

Mr. ASHLEY. May I interrupt?

It seems to me that by giving the banks the opportunity to get a greater return for their CD's, this encourages at a time of restraint, at a time when the Board is seeking to restrain it, the banks, the commercial banks, have opportunities to invest their now relatively easy obtainable funds in short-term loans as against and distinct from—and I do not think that that is an economically wise thing—at a time when restraint is necessary, particularly when the concomitant result is that there is a relative diminution in funds available for what in fact is a socially desirable purpose, even during a period of restraint; namely, the construction of at least a minimum number of homes for an increasing population.

Mr. MAISEL. I agree with your point entirely, except in the causal factor. In fact, I feel even more strongly than you as to what the problem is here. But I think the idea that setting a lower regulation Q ceiling, would fix this problem is incorrect. As an example, in the first quarter, we know that the relative flow to the money market from all savings institutions, including the commercial banks, was about even.

Now, in April, the commercial banks did a little better. But I still think that the problem is that all these institutions are competing with the money market and sales of goods. A great deal of the flow out of savings institutions arose from the fact that during the past 3 or 4 years they were not collecting real savings. They were collecting sophisticated money. It seems clear that they sought this larger investor kind of money from the type of advertising that has taken place in the financial press and from what we know of the type of money that has been attracted into savings institutions. Now there are fairly good indications that most of the money that has been flowing out, or a great deal of it, is this type of sophisticated money. It is not particularly flowing into the banks, it is flowing into the money market.

I have been told that for many institutions, because they have increased their rates in the last quarter, they have been getting more small accounts than they have had previously.

The problem here is that we are dealing with a question of competitive markets on a broad scale. This is what we have to be certain that everybody understands. Setting a lower regulation Q ceiling on time certificates or savings certificates or anything of that kind would not necessarily mean that savings institutions are going to have more money. It probably would mean that there would simply be less money available to all institutions to put into mortgages and things of that sort, because more of it would go ino the money market or be spent for current consumption.

Now, this flow has been attracted to the money market simply from the fact that when you use monetary restraint, interest rates have to go up. But I think that it is clear that we must differentiate. We should not accept the oversimple explanation, post hoc propter hoc,

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that it is the fact that Q ceilings were raised that is taking the money out of the savings institutions. If Q ceilings had not been raised, the money might have gone out even faster, and less money would be available to the mortgage market.

Mr. MITCHELL. Could I say just a word, Mr. Congressman, please?

First, about the relative advantage of the banking system as a result of the Q changes. Banks are paying 5¼ or 5½ for large CD's, and lending the funds at 5½. They are not making much money. The advantage to them is that it enables them to take care of their most urgent customers.

In the short run it is essentially a loss operation, not a profitable operation.

Now, on the second point, that banks——

Mr. ASHLEY. May I ask to whom they are lending it?

Mr. MITCHELL. To prime customers; they pay 5½ percent.

Now, the other point that you were making is that the banks, by virtue of the change in the CD's, have been able to get a larger share of the market.

Banks' share of total funds raised in 1965 was just under 40 percent, and in the first quarter of this year it is 25 percent. Banks, in fact, are getting considerably less than they got last year. And this ties into what Governor Maisel was saying, that the capital markets are the gainers; these funds are not going into the banking system from savings and loan associations, they are going into the market.

Mr. OTTINGER. $17½ billion went into CD's, did it not?

Mr. MITCHELL. $17½ billion, no. The level of CD's outstanding last fall was $16.2 billion, and after the first of the year this total rose to about $17½ billion, so this is an increase of about $1.1 billion, but the annual rate at which additional funds are being supplied to all sectors was $88 billion in the first quarter.

Mr. ASHLEY. What was the volume, what was the amount in CD's, in 1960 or 1961?

Mr. MITCHELL. Zero. The large negotiable CD was introduced in 1961.

Mr. ASHLEY. What is it now?

Mr. MITCHELL. $17½ billion.

Mr. ASHLEY. From zero to $17½ billion?

Mr. MITCHELL. That is right.

Mr. ASHLEY. In how long?

Mr. MITCHELL. Five years, I would say.

Mr. ASHLEY. Where are those dollars coming from, Governor?

Mr. MITCHELL. Some of these came out of the money and capital market; some of them came out of bank demand accounts. After all, when a bank issues a CD, it is competing with its own accounts.

Mr. ASHLEY. How about savings and loan associations?

Mr. MITCHELL. Well, to the extent savings and loan associations had hot money, yes, it was attracted; but to the extent they had genuine savers, no.

Mr. ASHLEY. Do we know to what extent it came from the various sources that you have enumerated?

Mr. MITCHELL. Well, there is some conjecture on that.

Mr. MAISEL. Well, I can calculate here that for 1961 through 1965, the increase in savings and loan shares was about $50 billion. They

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were 62.1 in 1960; they were 111.2 in April. Whereas about 17 billion went into negotiable CD's during that period, that period showed one of the largest rates of increase in savings and loans in history.

Mr. ASHLEY. Obviously, we are talking about a period of enormous credit growth; is that not so?

Mr. MAISEL. That is correct.

Mr. ASHLEY. I would not expect—we still are faced with the fact that 17 billions of dollars are now in certificates of deposit that were elsewhere 4 years ago. That is the key point, is it not?

Mr. MITCHELL. There are several places they could have been. They could have been in the commercial banking system; in demand deposit accounts; in open book accounts; they could have been in nonnegotiable CD's; they could have been in the money market; they could have been in the stock market; they could have been in the bond market; and there is a billion dollars of foreign money in there on which you have taken the ceiling off.

Mr. ASHLEY. Well, do we know, Governor, exactly where these funds came from?

Mr. MITCHELL. Well, no; we do not know exactly where they came from; we know the sources they could have come from.

Mr. MAISEL. Let me put it another way: During this period the amount of liquid assets in the U.S. economy went up by almost 200 billion. That means that about 8 or 9 percent of the increase in liquid assets during that period was in negotiable CD's. Now, whether you think this is a large percent or a small percent to be made up of CD's depends on your point of view. I think a major point to be made is that this was the way a free market distributed the 200 billion of liquid assets that were created during that period.

Mr. ASHLEY. Well, I think that a matter of 1 percent, depending upon the extent to which your economy is sophisticated, could be very meaningful.

Thank you, Mr. Chairman.

The CHAIRMAN. At this point, I would like to place in the record a statement in the May 19, 1966, Daily Bond Buyer entitled "Banks Add $5 Billion of Tax-Exempts in 1965."

Without objection, it is so ordered.

(The article from the Daily Bond Buyer follows:)

[From the Daily Bond Buyer, May 19, 1966]

BANKS ADD $5 BILLION OF TAX-EXEMPTS IN 1965, RISE OF 15.4 PERCENT

WASHINGTON, May 18.—Insured commercial banks increased their holdings of state and local government bonds last year by 15.4 per cent over the previous year—a rise from $33.3 billion to nearly $38.5 billion—Federal Deposit Insurance Corporation Chairman K. A. Randall reported today.

The increase in commercial bank holdings of local government securities was slightly offset by a decline in all insured banks' investments in state and local bonds.

Mutual savings banks' holdings dropped from $367.8 million in 1964 to $300.2 million as of the end of last year, a drop of about 19 per cent, Chairman Randall said.

U.S. HOLDINGS DOWN

While insured commercial banks were adding to their investments in local government bonds, they were disinvestors in Federal government securities. Their holdings in this area dropped from $62.6 billion to $59.2 billion, a decline of about 5.4 per cent on a year-to-year basis.

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Total assets of insured banks, both commercial and mutual savings, rose by 8.6 per cent last year to a total of $426 billion. Deposits increased 8.1 per cent to $377 billion, while capital and surplus accounts, after a rise of $2.7 billion during the year, amounted to nearly $34 billion.

TOTAL LOANS UP 14.9 PERCENT

Assets of insured commercial banks, totaling $375 billion on Dec. 31, 1956, rose by 8.8 per cent during the year. Total loans, less valuation reserves, accounting at year-end for almost 54 per cent of the banks' total assets, were 14.9 per cent higher.

Continuing a strong rate of growth, commercial and industrial loans gained 18.6 per cent, while loans on real estate rose 12.9 per cent. Total consumer loans were 14.3 per cent higher, with closely similar percentage changes in installment and single-payment loans.

For the first time banks were requested to report separately on Federal funds sold, most of which were previously included in loans to banks, total Federal funds sold as reported on December 31 amounted to slightly over $2 billion.

DEPOSIT LIABILITIES

Deposit liabilities of insured commercial banks totaled $332 billion on December 31, after an increase of 8.3 per cent during the year. Time and savings deposits of business and individuals, which rose 15.4 per cent, accounted for more than two-thirds of the expansion in deposit volume.

Total capital accounts of insured commercial banks increased 9.0 per cent during the year. Almost three-fifths of the dollar gain was in capital stock, notes, and debentures.

Insured mutual savings banks reported an increase of 7.3 per cent during 1965 in their total assets. Total loans of these banks, about 98 per cent of which are real estate loans, were up 10.3 per cent for the year.

Deposits of insured mutual savings banks totaled almost $46 billion on December 31, following a gain of 7.3 per cent in 1965. Total surplus accounts rose 6.1 per cent to slightly under $4 billion.

The CHAIRMAN. Mr. Talcott.

Mr. TALCOTT. Thank you, Mr. Chairman.

I have a couple of rather random comments.

First, I am pleased with the testimony of the Federal Reserve Board, Mr. Robertson.

I am pleasantly surprised, in a way, that you did not follow right along with the administration, because sometimes I feel that you do not show as much independence as you have a right to exercise. I am pleased also that you have recognized that Members of Congress sometimes get pretty panicky during an election year and want to appear to be doing a lot of things for particular industries. We have a national interest that we must consider at the same time, and so I was relieved when you indicated that you were going to exercise caution and study this problem more fully before you make any drastic recommendation or accede to executive or political proposals.

I commend you for this good and sound approach to a very complicated and complex problem.

I was curious, Mr. Robertson, about your vote on the various increases in the rate ceilings. Could you tell me whether you voted for the increases in the rate ceiling that you mentioned earlier in your testimony.

Mr. ROBERTSON. The answer is "I did not."

Mr. TALCOTT. Over the whole 10-year period, you did not vote to increase——

Mr. ROBERTSON. Well, now, I expect I could go through this and tell you.

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I think you will find that I did not vote—I did vote for one, I believe, when that was raised at the time we raised the discount rate, we raised the ceiling on time certificates up to a point equal to savings deposits, but I have never voted to authorize the payment of a rate to a business concern higher than that which a bank could pay to an individual, because I think Government should never be in a position of saying to a bank "You cannot pay to a small or an individual person as much as you pay to a large one." So, I have never done that, but I think you will find me on the opposite side in most of those cases.

Mr. TALCOTT. Well, it is good to be on one side most of the time, I suppose, and yet keep flexible so that we can vote differently at times.

I think we proved this in Congress. Where it used to be pretty certain that the Congress would protect, or even watch out for, the small investor, last week I think Congress neglected the small investor. So even Congress can make some sudden dramatic changes in its attitude. You can no longer expect them to act the same way consistently.

Isn't that right, Mr. Chairman?

The CHAIRMAN. I appreciate your interest in a low interest rate. I think you will be given an opportunity to vote on that pretty soon.

Mr. TALCOTT. We had that opportunity last week.

The CHAIRMAN. Still complaining about high interest rates, and will you vote for a 4½-percent ceiling?

Mr. TALCOTT. I voted for it last week; let's wait and see what I do next week. But, I think, sometimes, that governmental regulation can produce more problems than it solves.

Mr. Chairman, I have a short statement I would like to make if this is an appropriate time.

The CHAIRMAN. It may be included at this point.

(The statement subsequently submitted by Mr. Talcott follows:)

STATEMENT OF HON. BURT L. TALCOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Secretary Fowler has suggested legislation that would empower the Federal Reserve Board to set maximum interest rates payable on time deposits at 5 percent for deposits up to $10,000 and 5½ percent for larger deposits.

This proposal is apparently the Administration's response to the problems created by inroads of banks into the flow of savings to savings and loan associations and mutual savings banks.

During the first decade or so after World War II, savings and loan association deposits grew much faster than time deposits at either mutual savings banks or commercial banks. Despite their slower deposit growth, banks were able to meet customers' loan demands largely by increasing loan deposit ratios, which were very low owing to large acquisitions of U.S. Government securities during World War II. Until the mid-1950's, most commercial banks simply did not have to compete aggressively for savings accounts because they didn't need additional deposits in order to serve loan customers.

Things began to change in the mid-1950's. First, commercial banks' holdings of Government securities had fallen to more normal levels, relative to deposits and total assets. Second, commercial banks were becoming increasingly competitive in their lending operations—especially in the fields of consumer loans and mortgages.

As a result, the banks found it necessary and profitable to compete more aggressively for time deposits, and they began to pay higher rates. During the late 1950's, the spread between rates paid by savings and loan associations and mutual savings banks, on the one hand, and commercial banks, on the other, narrowed progressively. The Fed and the FDIC had, since the 1930's, imposed a ceiling interest rate of 2½ percent on time and savings deposits. This limitation had never before been an effective one, since before the mid-1950's banks had not wanted to pay more than the ceiling. When it became clear that the

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ceiling was getting in the way, the maximum was raised, first in 1957, and then in 1962, 1963, 1964, and 1965 to give banks the elbowroom they needed to compete aggressively. Without these relaxations of the ceilings, the competition of banks for time and savings accounts would have been largely forestalled. With them, time deposits of commercial banks have increased enormously in recent years.

Two separate facets of these developments must be distinguished. First, commercial banks were able to get an increasing share of the savings deposit business of households, farms, and unincorporated enterprises. This cut into the business of savings and loans and mutual savings banks.

Second, commercial banks, starting in the late 1950's, began to solicit time deposits from corporations, foreigners, State and local governments. Most dramatically, in 1961, the big New York banks reversed their policy of not accepting corporate time deposits and began issuing negotiable CD's, which are practically the same as Treasury bills from the holder's point of view. In addition, these large investors have acquired substantial nonnegotiable CD's.

An important further result was a rise in short-term interest rates, including rates paid on time deposits, savings and loan shares, and money market instruments, relative to long-term rates. The spread between short and long rates had accounted for much of the postwar profitability of the savings and loan industry. As this spread has narrowed, the industry's situation has become more precarious. The Federal Home Loan Bank Board put an administrative lid on interest rates paid by savings and loans in 1964 to avert what it felt were unsound tendencies. But as banks continued their invasion of the savings market, the Board's restriction became increasingly onerous and in consequence was relaxed last week. Now, savings and loans may pay as much as 5 percent on savings certificates held for 6 months or longer in areas where they face severe competition from banks.

This recent Federal Home Loan Bank Board action was prompted by a large outflow of savings and loan share capital following the quarterly interest payment date on March 31. Their loss, I am told, was well over $500 million. Mutual savings banks also lost heavily—over $300 million. It appears that these deposit losses have created something bordering on panic in the industry, which fears a repetition after the June interest payment date passes. One result has been a drying up of mortgage loan commitments by the savings and loans (and, perhaps, the mutual savings banks). If this is so (the facts are not easy to come by for such short-term developments) mortgage markets may become very tight. Up until this spring they have been less tight than they were in late 1959-early 1960.

The savings and loan industry and the building and real estate lobbies have swung into action to solicit relief. Beyond political considerations lie those of economic welfare of the country. The two should be distinguished. From the point of view of the national welfare, two opposing considerations emerge.

The Federal Reserve may be inhibited from pursuing an appropriate monetary policy because of the exposed position of the savings and loan associations and mutual savings banks. Monetary restriction raises interest rates, especially short-term rates. The present situation permits banks to pay up to 5½ percent on time certificates of deposit. Increasingly, banks have been issuing small denomination certificates of deposit, paying 5 to 5½ percent, to attract "small" private savers. Presently banks cannot offer more than 4 percent on passbook savings, and some of the sales of certificates of deposit have come out of passbook savings accounts. But they have also cut severely into S&L and MSB deposits. Further pressure on interest rates resulting from a tighter monetary policy would presumably aggravate the situation—especially in view of the Home Loan Bank Board's reluctance to allow savings and loans to raise their own rates to depositors. The question is whether such a policy would result in excessive restriction of mortgage credit, or in failures of some savings and loan associations, and how serious these results might be.

The Fowler proposal (or some variant of it) might make it possible to tighten money with minimum effects on the savings and loans and the building industry. The basic problem is to determine whether this is in the national interest, or simply in the interest of the savings and loan associations and the building industry. The stake of the latter is clear. The national interest is less clear.

What the Nation stands to lose by this kind of regulation, is the benefit that comes from the kind of competition in financial markets that has developed during recent years. In general, we would expect this competition to attract funds

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where they are most needed, and to see that they are channeled through those institutions or markets that can handle the job most efficiently.

The results of increased competition for savings during the past several years have been, in my opinion, enormously beneficial. Despite some regulators' contrary beliefs, free market competition in finance is an important ingredient of economic progress. It has made possible a tremendous improvement in the services provided by the banking system. Today's problem is probably more the result of too much regulation (S & L's are forced to put nearly all of their money into mortgages) rather than too little. History shows that one regulation breeds another. The Fowler proposal is an example. So are the proposals embodied in H.R. 14026 and H.R. 14422.

None of these proposals should be accepted without much more justification than has been provided so far. Not only should we be reluctant to grant further powers to restrict competition, but we should be doubly reluctant to permit further restrictions that reduce the returns to small savers and have a discriminatory effect on smaller banks. I am pleased that the Federal Reserve Board has refrained from backing the Fowler plan or either of the two bills before us today. The case for any of these measures is far from proved. Rather, the Board's testimony suggests to me the need for a full-scale study of policies to promote, rather than hinder free competition for the saver's dollar.

The CHAIRMAN. May I state to the witnesses here today: Obviously, we will not have an opportunity to interrogate you today, even if you come back tomorrow morning, which we hope that you will, and I just wonder if it will be all right, Governor Robertson, if you will speak for the others, that you will be glad to answer any questions that any member of the committee desires to submit to you in writing, before you look over your transcript?

Mr. ROBERTSON. I would be delighted.

Mr. TALCOTT. And each member has a right to propose some questions?

The CHAIRMAN. Certainly.

Mr. TALCOTT. May I ask just a couple questions now that may only emphasize what Mr. Robertson said.

Last Thursday, Secretary Fowler advocated restriction of rates paid on a time deposit up to $10,000, to 5 percent, even though larger deposits can earn 5½ percent.

This is hard for me to see, why the smaller depositor should be deprived of the same interest rate as the larger depositor.

The Secretary maintained that part of his rationale was because the smaller deposit was covered by the FDIC insurance. I take it that you disagree with the Secretary on this?

The CHAIRMAN. I believe Governor Robertson covered that in his statement.

Mr. ROBERTSON. I did cover it. I think you should never discriminate between the small and the large; the existence or nonexistence of insurance is a very weak reed to hang onto in trying to make a discrimination between the two, and you have problems.

Suppose an individual holds five different certificates of deposit, each of which is $15,000. Now, one of those, I would guess, the first $10,000, would be at the 5-percent rate, and the balance at 5½, but how about the others?

I do not know how it would work in that situation.

Mr. TALCOTT. At least half of 1 percent would be a pretty high rate to be paying for deposit insurance.

Mr. ROBERTSON. Well, would it be applied on each individual certificate?

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Suppose the depositor has a demand deposit of $10,000, that would exhaust his insurance; then, does the 5½ rate apply to the balance?

It is a very difficult thing to administer.

Mr. TALCOTT. Is that not a very good reason for not following the Secretary's suggestion?

Mr. ROBERTSON. I would personally think so.

Mr. TALCOTT. Then, with regard to the small banks again, and the small depositors, too, the small banks have mostly small depositors as you indicated, over three-quarters of all the banks with total deposits under $5 million have accounts of less of $10,000.

Mr. ROBERTSON. Much less.

Mr. TALCOTT. Only one-third of all depositors with the giant banks with deposits of over $2½ billion fall into that class.

Mr. ROBERTSON. I think that is about right.

Mr. TALCOTT. Then, the Fowler proposal would be, in effect, just not fair to the smaller banks. Would you interpret it that way?

Mr. ROBERTSON. The impact of it would be much greater on the smaller bank than the larger ones.

Mr. TALCOTT. Suppose the interest rates were to rise further and the banks began to lose their time deposits; then, would the ceiling rates have to be raised?

Mr. ROBERTSON. Not with my permission.

Mr. TALCOTT. Do you think that would be the consensus of the Federal Reserve Board members?

Mr. ROBERTSON. You would have to take a vote—No.

Mr. TALCOTT. You think it would not?

Mr. ROBERTSON. I do not have any idea how they would vote on this. This would depend on judgment, and a lot of things—circumstances, and then again whether or not monetary policy would be more effective leaving it right there or taking it off.

Mr. TALCOTT. Do you think you have adequate powers or authority now, or will new legislation be necessary in order to increase the interest rates?

Mr. ROBERTSON. In my view, we have adequate powers now. If there is any way to make them more adequate, I would favor it; but I think we have enough power now.

Mr. TALCOTT. I have some other questions that I would like to put to the members of the Board, but my time has expired already.

The CHAIRMAN. Suppose you submit them in writing; would that be satisfactory?

Mr. TALCOTT. That will suit me.

The CHAIRMAN. And they may be inserted at this point in the record.

(Following are questions submitted to each member of the Board of Governors, Federal Reserve System, by Mr. Talcott, with Mr. Robertson's reply on behalf of all Board members:)

JUNE 3, 1966.

DEAR ——— ———: At the meeting of the House Committee on Banking and Currency on May 24, 1966, I was granted the privilege of asking several questions of each Member of the Board of Governors of the Federal Reserve System.

For the record, may I please have your complete, but succinct, answers to the following questions:

1. Has the pursuit of anti-inflationary monetary policy been hampered by fear of the effects of rising short-term interest rates on savings and loan associations and mutual savings banks?

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2. Do you, as a Member of the Board of Governors, favor legislation at this time to extend the Fed's powers to limit interest paid by commercial banks on time and savings deposits?

3. Do you, as a Member of the Board of Governors, believe that a difference of one-half of one per cent between the maximum rate paid on time deposits under $10,000 and the maximum rate on larger deposits is justifiable because of deposit insurance coverage of amounts up to $10,000?

Your usual splendid cooperation and accommodation will be greatly appreciated.

Warm personal regards.

Sincerely,

BURT L. TALCOTT,
U.S. Congressman.

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, June 13, 1966.

Hon. BURT L. TALCOTT,
House of Representatives, Washington, D.C.

DEAR MR. TALCOTT: This is in reply to your letter of June 3, 1966, to each Board member in which you asked three questions regarding interest rates and thrift institutions. I am replying on behalf of all Board members.

Question 1. Has the pursuit of anti-inflationary monetary policy been hampered by fear of the effects of rising short-term interest rates on savings and loan associations and mutual savings banks?

Answer. The short answer is "No." In formulating monetary policy we try to take into account the expected impact of various alternatives on all segments of the economy. We have during the current period of monetary constraint followed with special care the impact of monetary policy on the flow of funds to selected parts and institutions in the economy. Our continued examination of the various developing relationships has not, however, deterred the System from moving toward a more restrictive monetary policy in order to combat inflationary dangers.

Question 2. Do you, as a Member of the Board of Governors, favor legislation at this time to extend the Fed's powers to limit interest paid by commercial banks on time and savings deposits?

Answer. The Board believes that discretionary authority to "distinguish temporarily between these two markets (the large negotiable CD market and that for smaller time deposits) in setting ceiling rates might in some situations facilitate actions to smooth the transitory adjustment problems of competition for savings funds in smaller amounts without disrupting flows of funds in the money and capital markets."

Question 3. Do you, as a Member of the Board of Governors, believe that a difference of one-half of one per cent between the maximum rate paid on time deposits under $10,000 and the maximum rate on large deposits is justifiable because of deposit insurance coverage of amounts up to $10,000?

Answer. Insurance coverage is obviously valuable to the smaller depositor in that it eliminates risk to him. The precise value of insurance coverage, however, cannot be determined with exactitude. Furthermore, it seems clear that the value of insurance would be greater to depositors in some banks than in others, reflecting differences in exposure to potential loss.

Sincerely yours,

J. L. ROBERTSON.

The CHAIRMAN. Mr. Stephens.

Mr. STEPHENS. Governor Robertson, isn't what has happened so far, as the slowdown in the building trades and in the building business and in the inability of people to borrow, exactly what the majority of the Federal Reserve Board intended to happen?

Mr. ROBERTSON. Exactly. That is what a restrictive monetary policy does. It is designed to cut down on the availability of money.

Mr. STEPHENS. Was it envisaged that it would have such a drastic effect on the housing industry and the mortgage money as has actually come about? Was it expected that it would not be in just

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one area or two areas but would be a wider spread cutback than has actually happened?

Mr. ROBERTSON. You never know where the impact is going to fall the hardest. You would like to have the impact even over the entire economy; I, personally, would like to see it have its greatest impact where the greatest shortage exists, but you cannot do that with monetary policy. This is a general instrument which applies across the board.

Now, as to whether or not the impact has been greater than we expected, I would say, in general, no; we have to curb the supply of money and credit.

Mr. STEPHENS. You did not think it would take effect so rapidly?

Mr. ROBERTSON. In some areas the rapidity has been greater, perhaps, than was expected.

Mr. STEPHENS. Well, I would agree with you, that you cannot expect where the impact will fall, and, of course, a great deal of the impact falls on us here in the Congress. We agree with the objectives of the Federal Reserve, that we do not want to have a period of inflation, but we also do not want to have a depression in anywise either.

Mr. ROBERTSON. I think I might just say that there is not a single member of the Board who does not agree with you, that we cannot live with inflation. We do not want to manage monetary policy in any way which would result in inflation. As a matter of fact, it is our job to see to it that we do have stable prices.

Mr. STEPHENS. Investors in my area, and homebuilders, and others, say that the effect has been probably more drastic there because of the expansion of homebuilding in the last few years than it would have been in some other areas, other places, where you do not have the expansion for homes.

Take, for example, a community like Athens, Ga., where my home is. We have had, I am delighted to say, an expansion due to Federal research programs that have been placed at the University of Georgia, the expansion of the educational system. The new monetary policy has brought to a halt almost the entire activities in building at a time when really, sincerely, there is need to expand, and people are hurting for homes under the circumstances.

Is there any possibility of having areas relieved in that type of situation?

Mr. ROBERTSON. It can be done by selective measures taken by Congress, through such agencies as Fannie Mae or Federal Home Loan Bank loans, but you can't do it through a general monetary policy which has, by its very nature, to apply across the Nation.

Mr. STEPHENS. I appreciate that.

Another question I would like to ask is this: Who advised on cutting the military construction program of the United States, the $600 million military construction program? It was cited on the floor of the House, when we were debating another bill, as a way to curb inflation, and I can't understand why that particular thing would be selected when we were at war, and I wonder who advised the Secretary, McNamara, to cut it?

Mr. ROBERTSON. I can only tell you that this is a matter that the Federal Reserve neither can be credited with nor blamed for.

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Mr. STEPHENS. Well, I appreciate that, but wouldn't the monetary policy of the United States have something to do with that? If you try to curb inflation, wouldn't that be part of the monetary policy of the United States?

Mr. ROBERTSON. The monetary policy of the United States is developed by the Federal Reserve. That is the monetary policy. Now, to the extent that other agencies of Government, or the Government as a whole, do things that do tend to curb inflation, that is welcome, but it is their own business; not ours. We have not been consulted; we are not informed.

Mr. STEPHENS. Thank you very much.

The CHAIRMAN. Mr. Gonzalez?

Mr. GONZALEZ. Well, it appears as if the Federal Reserve System has not provided the commercial banks with the steady growth of reserves year after year to support their increased demand deposits. This, of course, forces them to bid the more aggressive banks for CD's and borrowings. In addition to CD's, I wonder if you would please list the various instruments which the commercial banks have developed in recent years in order to borrow funds?

Mr. ROBERTSON. Well, I would mention first the promissory notes that some banks have been issuing. They have changed the name of a piece of paper from a certificate of deposit to a promissory note and sold it, and on that they have no reserve requirements, on that they have no insurance assessments—this is a means for borrowing funds for as short as 5 days, which comes very close to being demand deposits. This is one.

Other ways include repurchase agreements and purchases of Federal funds. The Federal funds market has developed over the past 10 years.

Mr. GONZALEZ. Well, I notice in your last report, the 52d report, where you are recommending an extension of your authority over all insured banks, not only the member banks, but all insured banks, and, apparently from the report, I gather that one reason was the disturbance, from the point of view of the report, or the rate of withdrawal of banks from membership in the System.

Is this withdrawal really dangerous or does it just appear to be when you look at it over a 5-year period?

Mr. ROBERTSON. Let me start by saying, from my point of view—and I think my associates would all agree—that the burden of carrying on a central banking system for this country and having a monetary policy which applies evenly throughout the country calls for that burden to be shared by all commercial banks.

So, from my point of view, every commercial bank should be subjected to reserve requirements which are comparable to those applicable to other institutions.

Once you do this, those institutions should also have access to the benefits, namely, they ought to have access to the discount window in order to meet emergency needs for funds.

I would apply these rules straight through the banking system. The fact that banks are leaving the System now, because as nonmembers they have more money to invest due to lower reserve requirements is a disturbing factor, but it is not a matter of calamitous size, because we still have about 83 percent of the deposits of the country in member banks. Nevertheless, I do not think it is fair, myself, that some insti-

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tutions can escape reserve requirements simply by moving out of the Federal Reserve System.

Mr. GONZALEZ. I notice that quite some big ones have come into the System, though, lately.

Mr. ROBERTSON. I can't think of any.

Mr. GONZALEZ. New York banks?

Mr. ROBERTSON. No, that is switching, you see, from a State charter to a National, but that does not bring it into the System.

They were members when they were a State bank.

Mr. GONZALEZ. In view of this seemingly or apparently failure of the System to keep pace with banking needs——

Mr. ROBERTSON. There has been no failure of the System to keep pace with banking needs.

Fortunately, in the past 6 or 7 years, we have pumped reserves into the banking system in order to enable them to make loans and thus to expand the economy of this country.

I think the trouble is, at the moment we have too many funds, too many reserves. in the banking system. As a result, we have to curtail that, because the money supply now is too large in relation to the volume of goods and services available to purchasers; so, I think no one can say we have failed in making funds available to banks with which to make loans. If we had done more, we would have had inflation a long time ago.

Mr. GONZALEZ. That is why I couched my question in the words or phrase "appears to," because it seems you have this other development, unprecedented development in the tremendous growth in negotiable CD's and the more aggressive banks bidding for them on the terms that they have. Now, in other words, your opinion is that one is not necessarily the cause of the other, that is, your restrictions, or keeping pace with the banks' needs for reserves, are not necessarily the cause of the increase in the CD speculative field?

Mr. ROBERTSON. In my view, this does have some relationship. I think that, personally, the larger banks can obviate some of the impact of a restrictive monetary policy by buying funds in order to meet the demands of their creditors. But, overall, if you take the whole banking system, the extent to which we provide reserves or contract reserves is determined by whether or not we think the money supply is growing too slowly or too fast to carry on the economy of this country in a noninflationary way.

Mr. GONZALEZ. Why don't the banks raise more equity capital, or do they?

Mr. ROBERTSON. Banks, over the years, I must say they have raised equity capital but only reluctantly.

In many cases, this changes the ownership of the individual, one man loses control if he is not in position to buy new equity, and as a result of this reluctance they have sought other means of acquiring funds.

Mr. GONZALEZ. But they are pretty low in relation to their liabilities, are they not?

Mr. ROBERTSON. Lower than they have been at some times in the past; yes.

Mr. GONZALEZ. Thank you very much.

Mr. ROBERTSON. I want to say, however, that I do not think that, as a whole, the banking system is undercapitalized today. I do not think

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that, for a minute. I think they are perfectly safe and perfectly sound. This country is very fortunate to have as sound a banking system as it does have.

Mr. GONZALEZ. Thank you very much.

The CHAIRMAN. Mr. Mize?

Mr. MIZE. Thank you, Mr. Chairman.

Governor, part of the reasoning behind the raise in the rediscount rate and the raise of the Q ceiling in December was to put down the pressure on the inflational development; is that right?

Mr. ROBERTSON. That is right.

Mr. MIZE. Well, it did not accomplish what you all hoped; is that right?

Mr. ROBERTSON. Because it was not done in the right way, from my point of view.

You had better ask my associates now, as to their point of view.

Mr. MIZE. Well, now, is it not true that the prime rate that was being charged by the big banks to their borrowers had started to firm up long before you raised your rediscount rate in December? What I mean, they were more selective, because of the shortage of money; is that correct?

Mr. ROBERTSON. I think that is true.

Mr. MIZE. What do you think the 30 big banks in New York and Chicago who are using the high rate CD's have done with the funds they have attracted?

Mr. Mitchell implied that they were borrowing at 5½ and loaning at 5½, and that it was a loss operation.

Maybe that should be directed to Mr. Mitchell.

Mr. MITCHELL. Well, they have been trying to take care of their prime customers. But that is not the only thing that they have done.

In April of this year, they expected a larger loan demand than materialized. Having gotten ready for it, their alternative in that instance, though pretty hard to pinpoint, was State and local securities. Basically what they have done or what they are trying to do and have been trying to do in the period since last fall is have adequate funds available for their customers to whom they have had longstanding commitments. This was the main objective and the reason they are paying that price for funds.

Mr. MIZE. In other words, they were suffering from the squeeze on, or the shortage of funds in general, and by your action, the action of the Board, you enabled them to tap some more liquid funds?

Mr. MITCHELL. Yes, so they could do business at a loss, in effect, if they felt they had to. There is not much of an incentive here.

Mr. MIZE. How in heaven's name could you possibly conceive that that would result in less pressure——

Mr. MITCHELL. Mr. Congressman, it has resulted in pressure on bank customers because banks have been turning many customers away and getting others to defer their demands or to postpone them, and so more pressure has been exerted on bank customers than I think is generally realized.

Mr. MIZE. I think it is unfortunate that it has affected the small businessman more than the big corporate ones. It hurts the small businessman more, because interest represents a significant expense

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to him, but it represents not too much to the big borrowers, because of their higher income tax rate.

Mr. MITCHELL. I agree; this again is one of the shortcomings of monetary restraint. On the other hand, a modest-size bank has its own prime customers that it will take care of, too, and they may not be very large business.

Mr. MIZE. But an upward raise in the prime rate in the big banks causes the small banks, or gives them an opportunity to raise their rates.

Mr. MITCHELL. They probably started with a local prime rate of 6 percent and some of them are still there.

Mr. MIZE. Thank you, Mr. Chairman.

The CHAIRMAN. May I suggest that the differences between the small man and the big man and interest rates, I would consider three:

No. 1—the big man can deduct his interest—50 percent writeoff, taxwise. The little man, of course, is not in such a fortunate position; he does not profit to that extent.

Secondly, the big man can offer stock to the public, if interest rates are too high, but the little man cannot.

Finally, retained earnings are really costless capital to the big man, and he can draw on them. It is a great benefit. The little man has no retained earnings. So, the big man is helped greatly by high interest rates, whereas the little man is discriminated against.

That is my view of it. Do you agree with that, Mr. Mize?

Mr. MIZE. Well, generally, I would like to see the rates fall where they may. I think the action of the Federal Reserve in December helped the big man and hurt the little man. I will say that.

The CHAIRMAN. That is what I was saying.

Mr. MIZE. At the same time, Mr. Chairman, I regard you very highly, but I still am a great champion of the independence of the Federal Reserve System.

The CHAIRMAN. Independent up to a point.

Mr. MINISH. Mr. Robertson, on the top of page 6 of your statement, you say "negotiability does not, in and of itself, impair the liquidity of the issuing bank nor of the banking system as a whole." Does that statement cover savings and loans?

Mr. MITCHELL. No.

Mr. ROBERTSON. It was not designed to cover savings and loans at all. I do not know any savings and loan association that issues a negotiable time deposit.

Mr. MINISH. I was thinking of the banking system as a whole.

Mr. ROBERTSON. I was thinking of the commercial banking system.

Mr. MINISH. I just want to say that in the Newark metropolitan area, which has a population of roughly 18 million people, 1 of the savings and loan banks had withdrawals of over $1 million in 30 days, and they traced roughly 50 percent of that money to the 1 bank in the area issuing CD's.

Mr. ROBERTSON. Probably, however, those CD's were not big negotiable instruments but were the so-called gimmick instruments, the savings bonds and savings certificates.

Mr. MINISH. But it put this bank in a rather precarious position.

Mr. ROBERTSON. Yes.

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Mr. MINISH. In the Wall Street Journal today I noticed, "New York Banks To Issue Dollar CD's in London." Did you have an opportunity to read the article?

Mr. ROBERTSON. Yes, I saw it.

Mr. MINISH. Do you have any comment on it?

Mr. ROBERTSON. Well, it is a very interesting proposal, one that is going to deserve a lot of study.

My first question about it was what it would do to the balance-of-payments program, because I have a concern with this and, as I get it, it will have no effect whatsoever. They borrow funds. If they buy funds there and bring them to this country, as one of the papers said they intended to do, this would not improve the balance of payments at all because the short-term funds are now taken into consideration as increasing our liabilities, but they are not taken into consideration in arriving at balance of payments.

On the other hand, if that were to move the rates up so much that holders of American bonds were to sell the bonds and invest in these; then, of course, this would have an effect. But I really suspect that all this would do is to add more funds to the Euro-dollar market. It will be foreign dollars that they are bringing in, that they are attracting to themselves, and they will utilize those in connection with the loans abroad. To the extent that they take care of loans abroad that otherwise American banks here would make abroad, so much to the good. This has many aspects that I am not in position to discuss this morning, simply because I do not know.

Mr. MINISH. Now, Mr. Robertson, I have been on this committee now going on 4 years, and I am privileged for the first time to have so many members of the Federal Reserve Board here. The thing that has bothered me for some time is the question of the Open Market Committee. Sometimes it is referred to as a secret committee, isn't it?

Mr. ROBERTSON. I do not know what you mean by a secret committee. Obviously this committee's actions affect the whole market, and, as a result, no one attends these except the presidents of the Federal Reserve banks and the seven members of the Board and members of the staff of the Board and of each of these banks. But they are all sworn to secrecy. In fact, you do not have leaks from the Open Market Committee. You may have people saying that they have gotten a leak, but take my word for it, they have not.

Mr. MINISH. How many attend?

Mr. ROBERTSON. I would guess 40. Am I right about this?

Mr. MINISH. I would like the experience of attending one of your meetings. I would like an answer from you and each of the members. Would you invite me?

Mr. ROBERTSON. No; we would not.

Mr. MINISH. Would anyone else like to comment on that? I would like to have their comments.

Mr. Brimmer?

Mr. BRIMMER. I would not invite you.

Mr. MINISH. You would not?

Mr. BRIMMER. I would not.

Mr. MINISH. I want you to know that I swore to uphold the Constitution, when I was sworn in as a Member of Congress.

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Mr. ROBERTSON. This is Mr. Scanlon, the president of the Federal Reserve Board of Chicago.

Mr. SCANLON. I would not, Mr. Minish.

Mr. MINISH. Mr. Shepardson?

Mr. SHEPARDSON. No, sir.

Mr. MINISH. Mr. Mitchell?

Mr. MITCHELL. Well, I would like to invite you, but I do not think it would be an appropriate thing for us to do, and I do not think it would be consistent with the direction Congress has given us.

Mr. MINISH. Mr. Maisel?

Mr. MAISEL. I think that this is true. It would not bother me. I personally feel that the Committee ought to make a good deal more of its deliberations public. I do not think, though, that inviting you or any other individual would, necessarily, be the best way of doing it. That would be my only reaction.

Mr. MINISH. I have convinced myself that it is a secret committee. Thank you.

The CHAIRMAN. May I say this, that the Open Market Committee is composed of 12 members——

Mr. ROBERTSON. That is right.

The CHAIRMAN. The 7 public members of the Federal Reserve Board, and then the 5 members chosen from among the presidents of the 12 Federal Reserve banks. Now, you have no right to bring in those other seven bank presidents. You see, the law compels the formation of an Open Market Committee composed only of 12 members, but you are in violation of the law when after you bring in the 7 Federal Reserve Board members and the 5 presidents of the Federal Reserve banks to this secret room, you also bring in the other 7 and allow them to participate in the discussions. They do everything but actually vote. They are bound to have some influence. Why wouldn't any member of this committee or any Members of Congress be just as trustworthy in the public interest? Why those seven are selected by private commercial banks. Every board of directors is composed of nine members, six of them selected by the private banks. That makes all these presidents selected by the private banking system—they are allowed to come in, and you do not allow anybody else to come in.

I think that these presidents go right back and report to their directors. Naturally, they would, because they are selected by their directors, and these directors are interested in all kinds of businesses.

I have estimated, Governor Robertson, that at least 500 people in the United States know 10 minutes after that meeting is over what has gone on in there.

Is that estimate very large, in view of the fact that the 40 you admit are there, and these 12 presidents go right back—and may even communicate by wire before they get back. Don't you think 500 would be a reasonable estimate of the number of people that know what goes on at these secret meetings?

Mr. ROBERTSON. No, Mr. Patman, I must say I do not agree with you.

No. 1, certainly the law requires that there be a 12-man Open Market Committee, and I think I should say that we have the utmost respect for the law.

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The CHAIRMAN. The law says that there shall be 12 members.

Mr. ROBERTSON. Yes. Now, the question as to whether or not it is illegal for us to have those who are alternate members of the Open Market Committee in there with the presidents, I think is not debatable. I think that under the law we have the power and the right, the legal right, to have them present.

But let me tell you exactly for the record why we have them.

This is a training operation. We want to keep people as closely familiar with the operation of that Committee as possible, within the group, so that when it is their turn to act as voting members of that Committee, they know the operations, they know what is going on; they have prepared themselves.

But, in addition to that, we do gain real benefits from attendance by the presidents who are not voting members. When the vote is taken, of course they do not vote, but they do make a presentation to the Open Market Committee, giving us a picture of the economy in their particular districts, as it relates to, contrasts or accords with the picture of the economy as we get it on an overall basis. Now, I doubt very much that any president of a Federal Reserve bank reports to his board of directors on the Federal open market operations.

The CHAIRMAN. Governor Robertson, may I make this observation there?

Now, Mr. Hayes of New York, gets $75,000 a year. That is public money just the same as the rest of us get around here, and he holds that job by reason of the fact that six of those banker directors vote for him. Do you think he is going to fail to give them all of the information that he gets at these meetings? Don't you think it would be unrealistic to suppose that a president under those circumstances would not divulge to his board of directors, to the members of the board who elected him, what was going on?

Mr. ROBERTSON. I think it is very improbable that any president of a Federal Reserve bank ever reports to his board of directors on what goes on in the open market operations. Remember that every president who is selected must be approved by the Federal Reserve Board here. We must approve him, or he can't serve.

The CHAIRMAN. I do not consider that a problem. You have got to approve somebody, and whoever they put in there, if there is no objection, you would approve.

Mr. ROBERTSON. We have objected.

The CHAIRMAN. Well, very seldom. I doubt, if I asked you to bring in the ones you have objected to, that it would be over three—that was the Chicago bank, wasn't it?

Mr. ROBERTSON. I would not want to discuss it.

But I think they do not report back, and I think they are all quite aware of the position of the Board of Governors, that they should not report to their directors on what goes on in the Open Market Committee, and I am sure that this is adhered to by every president of the——

The CHAIRMAN. Mr. Gettys?

Mr. GETTYS. Thank you, Mr. Chairman.

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Mr. Robertson, the action of the Federal Reserve Board on December 6 last was intended to curb inflationary trends; is that correct, sir?

Mr. ROBERTSON. That is right.

Mr. GETTYS. Isn't it true that the purpose intended has been accomplished, except that it was not predicted that the building and construction field would be hit so hard?

Mr. ROBERTSON. I would say the more restrictive monetary policy in being today is having its impact in curbing the inflation——

Mr. GETTYS. The intended impact.

Mr. ROBERTSON. But it was not thought at the time that this would have the great impact on the housing industry that some people fear it is going to have.

Mr. GETTYS. Now, are there other fields which have been unpredictably affected by the Q action?

Mr. ROBERTSON. I cannot think of any. You do not mean the Q action, you mean the whole operation?

Mr. GETTYS. The whole situation, yes.

Now, you stated, Governor Robertson, that you would not have taken that action at the time, but you had other suggestions?

Mr. ROBERTSON. Yes.

Mr. GETTYS. If your suggestions had been adopted by the Board, what effect, as of this time, would your suggestions have had, or what would they have been?

Mr. ROBERTSON. I would be very glad to answer that with the recognition that no one can tell what would happen or could have happened if some other course of action were taken.

Mr. GETTYS. You still hold the same view now?

Mr. ROBERTSON. I still hold the same view now. If the desire at that time was to curb inflation, then the result to be achieved was to curtail the expansion of bank credit and the money supply of the country, and the way in which I would have suggested doing that would be to hold the ceilings on interest rates on CD's exactly where they were and let the banks get needed funds from the discount window of the Federal Reserve.

Remember, you do not act simply to push interest rates, because interest rates, in my opinion, do not have as strong an impact in curtailing the impact on credit as many people think. As has been pointed out here this morning, large businesses can write off half the charge. The interest rate does not mean any difference in borrowing. They need money to carry on the business, which is a profitable business, and if they do, they are going to get the money, and. consequently, I would have made it impossible for banks to expand their credit as fast as they did by merely raising the interest rates on CD's and getting more funds with which to do it. I would have raised the discount rate, but I would have used open market operations then to reduce the availability of funds, and this would have resulted in a slower increase——

Mr. GETTYS. Longer overall time?

Mr. ROBERTSON. You still would have the effect of restrictive monetary policy.

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The other action would have followed: Instead of using interest rates as your goal, use them for a signal for whether your actions are right or wrong, accurate or inaccurate.

Mr. GETTYS. You think the Board has now the power to correct and control the situation without additional legislation?

Mr. ROBERTSON. I do.

Mr. GETTYS. I believe that is the view of other members of the Board; is that correct?

Mr. ROBERTSON. They are all here.

Mr. MAISEL. Congressman Gettys, I think we ought to be clear that we are discussing two separate matters. One has to do with the impact of tighter money on the homebuilding industry. I gave a speech on December 28, 1965, in which I predicted just about exactly what has happened. The speech was written just after the discount rate increase. I think anybody knowing the way monetary restraints work would agree that they did expect what has happened to happen. No one should be surprised.

I am sure most members of the Board were well aware of the fact that when you use an overall monetary policy, it has a primary effect in the mortgage market.

Mr. GETTYS. You predicted it would have a selective impact?

Mr. MAISEL. Yes, that has been the case every time monetary policy has been used. When you ask whether we should or can correct the situation the answer is not so clear. We have the ability to do what we think is correct with respect to the competition among financial institutions. We do not have similar power with respect to competition between the mortgage and money markets. Congress has that power.

I think the traditional way to correct a lack of mortgage money is through something like Fannie Mae. If Congress believes that the housing market has suffered, it seems to me that it is up to Congress to see whether they want to exert their legal authority through Fannie Mae or in other specific areas. This was the answer of Governor Robertson. Fannie Mae is set up so it can have a differential impact in a specific market.

Another way that the Congress has set up to take care of this problem is through advances of the Federal home loan banks. That is a second one. It seems to me proper that in the past Congress recognized the impact of monetary policy, in a selective field; namely, the mortgage field, and found ways to develop its own tools to deal with the problem.

Now, the Federal Reserve can't solve that problem if it is charged with enforcing monetary restraint. We must be conscious of that. I do not think any changes in regulation Q, in a period of monetary restraint, would do much toward solving the problem of the mortgage market or the housebuilding industry.

Mr. GETTYS. Thank you. I would like to pursue that, but my time is up.

The CHAIRMAN. Mr. Halpern.

Mr. HALPERN. I would like, Mr. Chairman, to take this opportunity to ask an expression of views by this distinguished panel on a most timely and pertinent matter, one that has a direct relationship to monetary policy.

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Would each of you express your opinion on this committee's recent action in recommending that the Congress grant to the President standby controls over consumer credit?

Mr. ROBERTSON. I will be glad to give you my answer.

Mr. HALPERN. I will be very happy to hear from you.

Mr. ROBERTSON. I think that there are periods in which selective controls can be effectively used and can serve a purpose. I generally am opposed to selective controls and prefer general controls because of the very great difficulty of administering those selective controls like consumer credit, on an equitable basis.

This goes not only to controls on consumer credit, but controls on real estate credit as well, such as we had under regulation X once before. Any selective control of this kind is unfair. There are always ways to evade and avoid it, and consequently I would hope to avoid the use of it. But on a standby basis I would not rule them out, because I think there are occasions when that may be the real thing that you need for a very short period of time, and I would like to use it, and I think it is important for a short period—as short a period as possible.

Mr. HALPERN. Would you do it now?

Mr. ROBERTSON. No, I would not.

Mr. HALPERN. You would not now?

Mr. ROBERTSON. No.

Mr. REUSS. Would the gentleman yield?

Let me understand the question.

Mr. ROBERTSON. I would not apply them at the moment.

Mr. REUSS. Would you accept the power to have the option to apply?

Mr. ROBERTSON. On a standby basis, yes, but I would not apply it if I had the power, as of the moment.

Mr. HALPERN. Mr. Shepardson?

Mr. SHEPARDSON. I have substantially the same view as Governor Robertson. I think, under certain conditions, they may be used effectively. It seems to me that selective controls are extremely difficult to use. A nationwide regulation that would fit the various situations, is so difficult to formulate, and evasions are so great that it is of doubtful value in most circumstances. Under the impetus of an all-out war, the readiness of people to abide by such regulations is an expression really of patriotism, and under those circumstances you may effectively use that type of an instrument.

We had selective controls before, and it did not take very long before we experienced evasions that were almost uncontrollable.

I think I would agree with Governor Robertson as to their value as standby powers. I think they should be used rarely and under only the greatest pressure.

Mr. HALPERN. You do not think this would be a time to grant them?

Mr. SHEPARDSON. No.

Mr. HALPERN. Mr. Brimmer?

Mr. BRIMMER. Mr. Halpern, I share Governor Robertson's and Governor Shepardson's views on the usefulness of standby controls over consumer credit, however, I would add a footnote. I think at this time the decision by the Congress to grant such a power might be interpreted in a light different from what the Congress intended.

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While Congress might intend to provide these as emergency measures, the public may interpret the action as a directive to the Federal Reserve to apply the controls at this time along with other general monetary instruments.

Therefore, I would not encourage the Congress, if they were to ask my opinion, to enact such legislation at this time.

Mr. HALPERN. Would you use it currently?

Mr. BRIMMER. I would not under current conditions.

Mr. HALPERN. Mr. Scanlon?

Mr. SCANLON. I share Governor Robertson's view, Mr. Halpern. I do have great hesitation about the administration of selective control regulations in peacetime periods. From experience, during the wartime period, they were difficult to administer and I would have some reservations on the administration now, but I would give the President standby authority, though I would not invoke such authority presently.

Mr. HALPERN. Mr. Mitchell?

Mr. MITCHELL. I would have no objection to the power being conferred, but I would certainly feel that from the evidence before us at the present time there is no need for it to be conferred at this particular time, and the implication that it ought to be used I think would be unfortunate unless facts change.

I would also say that along the line Mr. Mize was following a little earlier, that this is another place where the impact of monetary restraint is now being felt. As some banks have come under increasing pressure some of the finance companies have had difficulty in holding onto their bank loans.

Mr. HALPERN. Mr. Maisel?

Mr. MAISEL. I think the standby controls should have been retained as a permanent part of the anti-inflationary powers of the Government.

Mr. HALPERN. Is that affirmative?

Mr. MAISEL. Yes, they—that is, the standby powers to use controls over consumer credit in case of need—should have been made permanent instead of having been allowed to lapse in the fifties.

Mr. HALPERN. Would you apply them now?

Mr. MAISEL. No, I would not.

Mr. HALPERN. Mr. Treiber?

Mr. TREIBER. I share the general views expressed so far. Under the present circumstances, I think that general policies—monetary policy and fiscal policy—are called for to fight the inflation. I see no objection to the existence of consumer credit standby authority, but would consider it unfortunate if the enactment of that legislation at this time were interpreted by the public as suggesting that it be used as an alternative for fiscal and monetary policy.

Mr. HALPERN. Thank you, Mr. Chairman.

The CHAIRMAN. We will recess until 10 o'clock in the morning, and we would like for all of you gentlemen to be back here if possible.

Mr. REES. Would the chairman yield?

I introduced a bill, H.R. 15173, which is aimed at developing some type of control over certificates of deposit, or at least defining them.

I was wondering if the Board might look at the bill between now and tomorrow morning, at which time I would appreciate your comments.

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The CHAIRMAN. It is considered relevant to this particular bill that is now under consideration, and, naturally, we want consideration given to it, if you will, please.

Thank you, gentlemen, very much.

(Whereupon, at 12 o'clock noon, the committee adjourned to reconvene at 10 a.m., Wednesday, May 25, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

WEDNESDAY, MAY 25, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Moorhead, St Germain, Grabowski, Gettys, Todd, Ottinger, McGrath, Annunzio, Rees, Widnall, Fino, and Johnson.

The Chairman. The committee will please come to order.

Today the committee continues hearings on H.R. 14026 and related bills. I want to take this opportunity to briefly express my thanks to the Board for appearing before the committee, and commend them for the forthright way in which they defend and argue for their various positions.

Although it is apparent that not all of the Board members think exactly alike, you all must still be given full credit for the sincerity and honesty of purpose which you always exhibit. As witnessed by the Board's vote on the December 6 action and as witnessed by the various positions taken in answering questions asked by members of this committee we obviously all do not interpret facts in the same way.

I must also take this opportunity to deplore the fact that Chairman Martin has refused to appear at these hearings either last week or this week, due, as he expressed it, to a conflict in schedule. The committee, of course, was anxious to have all members of the Federal Reserve Board appear to assist us and the Congress in arriving at a solution to a problem which has devastated the thrift industry, the construction industry, the building trade unions, prospective home buyers, small businessmen and many others. This situation in my opinion, and in the opinion of many, has resulted directly from the action taken by the Federal Reserve Board in December 1965.

Initially, I understood that Mr. Martin had to attend an official intergovernmental meeting in Europe. I have since learned, however, that Chairman Martin and Governor Daane were not attending an official meeting of governments but rather attending an American Bankers Association international convention in Spain. Apparently from the picture in the morning paper Chairman Martin and Governor Daane feel that it is more important for them to attend a convention whose one purpose, at least according to the morning paper, seems to

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be more in the nature of a fiesta rather than a work session. Many of us were somewhat disturbed over the fact that these gentlemen have placed bullfighting above the importance of arriving at solutions to the problems of the American economy.

I understand that the House will be meeting at 11 o'clock this morning. We will go as far as we can with a continuation of questioning of members of the Board by the committee, and if necessary we will ask the Board to appear again tomorrow or at another agreeable time.

Governor Robertson, this is too serious of course, for levity, but I would like to ask, does the Federal Reserve have colors of its own?

Mr. ROBERTSON. Have what?

The CHAIRMAN. I notice this Governor went into the bull ring with the Federal Reserve. I wondered if the Federal Reserve had colors.

Mr. MAISEL. Green.

The CHAIRMAN. Green would be better than greedy.

Anyway, seriously, do you have colors? Do you have a standard?

Mr. ROBERTSON. No; we do not.

The CHAIRMAN. That was a mistake. That was a little levity.

STATEMENT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; PRESENTED BY J. L. ROBERTSON, VICE CHAIRMAN; CHARLES N. SHEPARDSON, MEMBER, GEORGE W. MITCHELL, MEMBER, SHERMAN J. MAISEL, MEMBER, AND ANDREW F. BRIMMER, MEMBER; CHARLES J. SCANLON, PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO; AND WILLIAM F. TREIBER, FIRST VICE PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK—Resumed

The CHAIRMAN. Mr. Todd is here now and since it his turn to question the witness, I will call on him next, but I introduced a House Joint Resolution No. 1148. It is short and I will read it.

> SECTION 1. Notwithstanding the provisions of section 19 of the Federal Reserve Act and section 18(g) of the Federal Deposit Insurance Act, no bank (other than a mutual institution) whose deposits are insured by the Federal Deposit Insurance Corporation may pay any interest, discount, or other return on any time deposits, savings deposits, or borrowings at a rate in excess of 4½ percent per annum or such other rate as may be established by the Board of Governors of the Federal Reserve System with the approval of the President.
>
> SEC. 2. The provisions of this resolution shall be applicable with respect to—
>
> (1) savings deposits held, and
>
> (2) borrowings and time deposits obtained or renewed during the two-year period which begins on the day after the date of enactment of this Act.

Briefly, I know you gentlemen quickly interpreted this the same way it is intended, for a 2-year period that this rate will be a limit of 4½ percent. During that time it may be changed with the approval of the President. How would you feel about that, Governor Robertson?

Mr. ROBERTSON. Just off the cuff, I think this would be a tremendous burden to place on the President, to decide the rate of interest which should be a ceiling on interest deposits.

The CHAIRMAN. We want to go into this somewhat. This thing is so serious. Will you gentlemen be able to be here tomorrow morning?

Mr. ROBERTSON. I will be able to be here tomorrow morning.

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The CHAIRMAN. It looks like we will have to come back. It does not look as if we will be able to finish. Some members want to study these and some members have proposals of their own.

Mr. Todd, you may proceed.

Mr. ROBERTSON. Could I just say, Mr. Chairman, in response to the question that was just raised by Mr. Rees yesterday, a statement with respect to his proposal which I would like to submit for the record? I do not have copies, but I will send those copies up today.

The CHAIRMAN. Well——

Mr. ROBERTSON. I will have them here this morning.

Two of my associates also have statements.

The CHAIRMAN. You may insert them at this point.

(The statements referred to follow:)

STATEMENT OF J. L. ROBERTSON, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ON H.R. 15173

At the committee hearing yesterday, Representative Rees asked the Board to comment on H.R. 15173 at this morning's session. From our very brief study, it appears that the bill has three main provisions. It forbids insured banks (1) to issue interest-bearing negotiable certificates of deposit or other negotiable instruments, (2) to pay interest on time deposits held for less than 1 year, and (3) to pay higher interest rates on time deposits than on savings accounts.

The Board views such blanket prohibitions on competition for savings as detrimental to the public interest. They would erect legislative barriers to a free movement of funds that has great potential for increasing efficiency in financial markets. In their efforts to compete for savings of individuals, banks would be effectively limited to the acceptance of passbook savings, since few individuals would be willing to hold time deposits with a maturity of a year or more at interest rates no higher than those on savings accounts. The result of such legislation might be that the maximum rate on passbook savings would have to be raised to prevent banks from being barred from effective competition with nonbank intermediaries.

The bill's prohibition of negotiable CD's is the same as that of H.R. 14026. Our objections to that bill thus apply to this bill also.

The other two provisions of H.R. 15173 seem unwarranted. As we noted yesterday, time certificates have been used in some sections of the country for many years as a medium for the investment of savings by individuals and other small investors. These certificates frequently have a maturity of less than 1 year. Maintenance of a solvent and liquid banking system does not require that all such certificates should have a maturity of 1 year or more. Time deposits of fixed maturity permit banks to tailor their asset structure to the maturities of their liabilities. With time deposit maturities of appropriate length, there is justification for permitting rates on time deposits to exceed those on savings accounts, which are in practice paid on demand.

In the past, Congress has taken the view that considerable latitude should be provided to the regulatory authorities for adjusting ceiling rates on time and savings deposits in the light of unfolding economic developments. As we noted yesterday, the Board welcomes consideration of measures directed at increased flexibility in administering interest rate ceilings. This bill, in our judgment, moves in the wrong direction, by providing a statutory prohibition and a statutory freezing of certain interest rate relationships on banks' time and savings deposits.

The changes in financial flows and in competitive relationships among financial institutions that seem likely to result from this bill are drastic. Such legislative action hardly seems appropriate to a competitive situation which, though it requires careful surveillance and possibly action to avoid excesses that might unduly harm particular sectors of the economy, at the same time offers promise of substantial gains in economic efficiency and in incentives for saving.

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STATEMENT OF SHERMAN J. MAISEL, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, ON H.R. 14026 AND RELATED BILLS

1. This is a proper period for the use of monetary restraint. Failure to do so without taking alternative actions might speed up inflation and aggravate a sticky balance-of-payments position.

(a) The demand for goods in the economy at the moment is pressing too hard upon our physical capacity to produce and therefore is tending to generate sizable price increases.

(1) Generally, I think we would be better off if the bulk of excess demand is removed by fiscal rather than monetary policy, since extremes in the application of monetary policy create large problems for the economy. The timing of monetary (rather than tax) restraints is less certain. Monetary restraint's differential impact on parts of the economy probably is greater than that of fiscal policy, while its final incidence on subgroups in the country is probably less certain.

(2) On the other hand, given the decision to rely upon monetary instead of greater fiscal restraint, I believe that monetary policy should be made as effective as possible.

(b) In the current situation, higher interest rates and tighter credit availability in the United States will aid the balance of payments. Again, I feel other steps to correct the balance-of-payments situation are preferable, such as the use of taxes, tariffs, and other governmental policies. Since such steps have not been taken, monetary restraint and higher interest rates are necessary to aid in the adjustment process of bringing about an equilibrium balance of payments.

2. Given a decision to adopt a policy of monetary restraint, raising the ceiling of regulation Q, and not adopting a split rate, was a proper corollary to the rise in the discount rate last December.

(a) I do not believe that small savers should be discriminated against in favor of large savers, corporations, or financial institutions. If Congress decides to penalize small savers, I would help to enforce such a decision, but it seems to me enforcing a lower rate of return for the savings of a selected group of citizens without considering carefully other alternatives would conflict with the best traditions of the American way of life.

(b) I think the previous use of interest-rate ceilings to halt normal competition among savings institutions turned out to be unfortunate for the country. The protected position of some institutions resulted in a good deal of waste and inefficiency. Unless there is a real danger from excessive competition, or unless the period is one in which the market is acting in a destabilizing manner, one should hesitate to impose ceilings on wages, prices, interest rates, or any other good without a clear theory as to what the ceiling is to accomplish, who is to gain by it, who is to pay for it, and whether the ceiling is the most efficient form of transferring money from one group to another.

While we have no exact figures yet, there are indications that some small savers are responding to the appeal of higher rates by increasing their savings. This is exactly one of the developments that is desired as a result of monetary restraint. It is a major reason why the savings institutions now should have some freedom to increase rates—to stimulate, and to share in, a larger financial savings flow.

(c) I doubt that a ceiling on either negotiable CD's or on small ones would give the results some hope for. Thus far it certainly appears as if competition among institutions has aided savers. At the same time, we have no proof that it is the major cause of the April losses in some institutions. From all appearances the main competition thus far has been between the money market and all financial institutions for sophisticated money. Imposing a ceiling of 5 percent on $100,000 CD's might simply force money into U.S. Government agency issues at 5.5 percent or into other market instruments.

Many of the major losses of funds seem to have centered in savings institutions that knowingly risked this situation by departing from their normal scope of operations. It was a risk that I and most regulatory authorities deplored and called specifically to their attention in public statements. Some simply tried to expand by attracting larger deposits. Others went further. To strive for increased profits, they sought money-market money rather than real savings and used that money for lending on more speculative properties at higher rates. The average stability in a given institution of small savings still seems to be much greater than for larger blocks of funds. Such stability should not have been expected for larger savers. Should the small thrifty family that

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is not at fault be penalized before we have better proof that such action would stabilize sufficient funds to make the inequity worthwhile?

3. I should make it clear that if our survey shows that unstable conditions exist, or that a further ratcheting of interest rates without productive results appears imminent, I would vote to impose some stabilizing regulations even at some sacrifice of both fairness for the small saver and the efficiency expected from the market. But I would do so with a great deal of unwillingness, and such a decision would require a particularly careful measuring of alternatives.

I am concerned with the potentially greater instability of larger CD's. I do not, however, feel that their existence can force the Board to raise the Q ceiling, any more than their existence last December seemed to me then to lend weight to the argument for raising the discount rate. I believe that at the present, within rather broad limits, the discount rate is a price fixed by the Board and not the market. The existence of market rates against the ceiling may lead to a particular distribution of credit which differs from that which would exist without the ceiling. The question which must be answered is whether such a distribution is desirable and for how long the pressure can be maintained given the facts that money is fungible.

4. These hearings have properly called attention to the fact that even though monetary policy is applied generally, its major impacts center in certain selective markets. These costs which result from restraints must be measured each time monetary policy is used. When, as in the current period, a decision has been made to use monetary restraint in place of more pointed and vigorous fiscal and balance-of-payments procedures, then these particular costs will be experienced.

If in the circumstances, Congress believes that selective cushioning is needed for the areas hit hardest, clearly they should consider taking special action. I have gone on record on numerous occasions over the past 10 years to the effect that Congress has properly established the special assistance program of FNMA and the advances of the FHLBB to deal with such a problem. They represent ways of putting money directly into the housebuilding market when a determination has been made that such areas are suffering too much as a result of the application of general monetary policy.

If it appears that the pinch of monetary restraint is too great in particular spheres, action should be taken either to substitute other types of policy for monetary ones or aid should be given directly to the sectors where the cutbacks appear to be antiproductive from the point of view of the economy as a whole. Until evidence is available to the contrary, however, I believe the most reasonable presumption is that special ceilings on all, negotiable or small, CD's would not offer sufficient aid to the mortgage market to make worthwhile the sacrifices they would entail for savers, other institutions, and many borrowers. A Pandora's box might be opened in which decisions now made by the market as to how to distribute savings among institutions and borrowers would have to be made by law or governmental fiat. This I am certain we would all much prefer to avoid.

Statement of George W. Mitchell, Member, Board of Governors of the Federal Reserve System

I would like to briefly state my basic reasons for believing that the Board's position with respect to regulation Q ceilings is appropriate at this time. In doing so I want to make clear that I do not project this view into a future in which conditions may be changed or changing.

I start with the proposition that the broad subject with which this hearing is concerned is a flesh-and-blood problem, and I would like to recall my diagnosis of its potential in a speech I delivered several months ago, and has previously been referred to by Mr. Strunk.

At that time I considered in what respects contemporary credit developments might, from either the overall or the structural view, become a cause for concern. My choice of something to worry about, which may yet turn out to be a real menace to our credit structure, was not that we had too much debt in the aggregate or in broad economic sectors; nor was it the level of credit quality which could be safely serviced by an expanding economy. Rather, it was the growing business of borrowing short and lending long—the transformation of liquid claims into long-term credits by depository intermediaries.

Back on October 22, 1965, I pointed out that for the saver and investor these intermediaries were offering the best of all possible worlds. Thus the investor

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had a highly competitive return on his funds, and yet by prevailing practice he was always instantly able to convert his deposit into direct expenditure or direct investment if market conditions open up more exciting earning opportunities. The channeling of these flows into long-term instruments has also provided more ample funds for use by corporations, individuals, and the various units of government. And financial intermediaries themselves by lengthening their portfolios and broadening their range of assets have been able to live well off an increasingly slender interest rate differential.

"In surveying these uniformly pleasing results, however," I noted, "that the question naturally arises whether they have been obtained by risking serious destabilizing repercussions in the future. Certainly while banks and other savings institutions have been expanding the volume of liquid claims in the hands of the public, they have been assembling in their own hands an entirely different time profile of matching assets. Not only are their loans and investments far less liquid than the claims against them as has always been true; they are far less liquid than they were 5 or 10 years ago."

I went on in that speech to point especially to the liquidity risks attaching to CD issuance, but my remarks could equally well have been punctuated by illustrative references to the risks inherent in the passbook share accounts of savings and loan associations.

"In considering the vulnerability of depository institutions to savings outflows," I said, "the potentially disruptive contingency—and the one that is most likely to create a challenge to monetary policy—lies in the possibility of relatively sudden shifts of funds from 'time' deposits to direct investment in equity or credit markets. In this respect, negotiable certificates of deposit constitute the most vulnerable segment of the total since they are directly competitive with the full range of money-market instruments and are held by corporations and other institutions likely to respond quickly to relatively small shifts in yield differentials. Indeed, the most immediate and direct constraint on monetary policy posed by the new profile of bank liabilities may lie in the need to weigh carefully the impact of specific actions on such differentials.

"More broadly, those charged with formulating monetary policy must recognize that the process of transforming liquid savings into long-term instruments does lack some of the automatic checks and balances inherent in a single contract between the original saver and the ultimate borrower. A widespread shift by depositors to other forms of asset holdings—say a move by corporate holders of negotiable CD's into market instruments or by individual savers into common stocks—might force readjustments in bank assets that would have serious repercussions on those credit markets in which banks are inactive and into which it may be difficult to entice other investors without significantly higher yield incentives.

"This would be particularly likely in markets such as those for municipal bonds and mortgages where bank participation has increased sharply in recent years. It might well occur whether the readjustment undertaken by banks losing time deposits was confined to reduced takings of new issues or extended to actual liquidation from existing portfolios."

These comments foretold a contingency which began to come into being with the December 1965, tightening in monetary policy and the subsequent rise in market interest rates. A major asset adjustment that would have been required of banks (and an unexpected impact on their customers) was partially eased by a change in regulation Q. This change permitted banks to offer higher rates for what amounted to about 14 percent of their total deposits. So far as the larger banks were concerned, it enabled them to be more competitive with the security markets. So far as the smaller banks were concerned, it enabled them to be more competitive for local pools of funds.

But in both instances the banks were also competing with each other and, more fatefully, with themselves. They had in passbook savings about $90 billion on which the ceiling was not changed. To a considerable extent they found promoting CD and open-book accounts at 4½, 5, or 5½ percent attracted large transfers from their own lower rate passbook savings accounts and thus only raised the price on funds they already had. This redundancy of cost had a substantial moderating influence on their competitive drive.

Furthermore, even with these higher deposit rates banks have not been able to fully offset the lure of high-yield market instruments for their customers; the most that banks altogether have been able to do is to keep up a positive net inflow of time deposits, but with a growth rate far below last year—a third less in January–April than in the comparable period of a year ago. Savings and loan

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association and mutual savings bank net inflows have also been dropping—to a rate only half that of 1965. Thus, all financial intermediaries have been feeling the tug of higher market rates of interest. Meanwhile the share of credit demands met through direct flows of savings to the market has risen sharply as savers bypassed banks and other intermediaries and put more of their funds directly into securities. Last year the banking system was able to accommodate two-fifths of the credit used by individuals, businesses, and governments; in the first quarter of this year, the banking system's contribution fell to only about one-quarter of the total.

What does this background of fact and principle signify for how we should approach today's problem?

I think it is clear that we all have a common goal of maintaining the stability of our financial institutions and of providing savers with the best yields and the greatest liquidity consistent with that stability. I would add that near-instant liquidity of time deposits at banks or savings and loan associations is a privilege that must not be too widely shared. It can hardly be shared at all with any very large number of that kind of depositors whose withdrawals are stimulated by rate incentives. A predictable, even though large, turnover in savings accounts is one thing, and well within financial managements' capabilities—a concentrated mass withdrawal to take advantage of rising yields is an entirely different matter and much more difficult to deal with. This is one reason for the Federal Reserve rules that today deny passbook accounts to business corporations and to State and local governments, two types of depositors who are exceptionally sensitive to rate differentials.

Today many depository institutions are recognizing the destabilizing threat of rate changes, and they are trying to stratify their depositors, according to sensitivity to yield differentials on the one hand and to desire for liquidity on the other. Those that are sensitive to higher yields are being locked in with varying maturity arrangements; this is a major virtue of the certificate of deposit. Those that are more liquidity conscious are being offered lower yields in passbook-type accounts.

The rates, terms, and conditions offered vary widely from place to place in the Nation, reflecting the great variety of economic and financial circumstances and the differing judgments of thousands of financial managements. In the process several new mutations of deposit instruments have taken place. A few such mutations may be bad, or at least nonprofitable in the longer run, but I regard as constructive those savings contracts that compel the holder to accept some meaningful restraints (maturity or otherwise) on his ability to demand cash from his depositary institution and then pay that holder well for his giving up of liquidity. And for this reason, denouncing longer maturity, higher yielding CD's just because they are of small denomination strikes me as antithetic, not only to equity but also financial stability.

In a problem as complicated as this one, it is possible to mistake surface symptoms for underlying causes of disequilibrium. The result of an erroneous analysis may be to damage our financial intermediary system, reduce the benefits of a competitive financial system, or to thwart the effectiveness of monetary action, the major instrument of public policy being used to counter emergent inflationary pressures at this juncture.

Bank and savings and loan competition has been vigorous for several years now. But it moved into the acute stage when monetary restraint reached its current levels and it became obvious that the aggregate of credit would not be large enough to go around. The problem, in my view, is linked directly to the way in which we are dealing with overheating, or the threat of overheating, in our economy. Were we using fiscal policy to counter these pressures, I doubt the issue we are considering today would even have arisen, greater reliance upon fiscal restraint would probably not have produced the monetary stringency we now see around us or may be expecting. Our problem is clearly worse, however, because financial intermediaries have implicitly promised more liquidity, yield, and accommodation to their customers than they can readily deliver.

Admittedly, there is room for differences of view on what, if anything, should be done now. In seeking solutions, we must keep in mind that there are both short- and long-run problems involved, cyclical as well as secular developments with which to cope. In the short run, we have to quell the hysteria and break the paralysis that seem to be gripping some participants in and observers of the financial scene. The financial structure is essentially resilient and well managed, and there exist governmental mechanisms established for the very purpose of easing adjustments that must come in the wake of shifts in demands for goods and for financial services. While not denying that a problem exists

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for all financial intermediaries—as a result of the Government's reliance on monetary policy as the main tool of economic restraint—the situation hardly warrants the crisis atmosphere that has developed in some quarters, or the overreaction by portfolio managers which threatens to curtail housing activity unnecessarily sharply.

What is important is to be sure that in dealing with the short-run problem we do not adopt solutions that in the long run will hurt more than help. I believe the best and most lasting solution lies in permitting intermediaries, savers, borrowers, and the market to work out their own salvation. Most of them are doing well enough now and others are taking constructive corrective measures. If governmental actions are needed, they should be actions designed to remove restrictions and inhibitions, rather than those which hamper adjustment to evolving economic needs.

I would like to add a postscript to my statement, with respect to the impact of monetary conditions of recent years on the smaller banks of the Nation and, by inference, on the effect of restricting their use of CD's and open-book accounts. Unfortunately, our statistical knowledge of how small banks are faring depends upon Call Report data which are not very current. From data for June 30, 1965, the latest information we have, I think it clear that small banks were holding their share of the market for demand deposits, losing out on passbook savings, gaining slightly on CD's and open-book accounts held by State and local governments and gaining well on CD's and open-book accounts held by individuals, partnerships, and corporations.

Using June 30, 1961, as a comparison year, defining small banks by the total of their deposits in each of these categories, and choosing deposit levels in each case to set off 75 percent of the 13,543 banks in the Nation, these are the results:

(1) Banks with demand deposits of less than $5,110,000 had 11.6 percent of the demand deposit market in 1961—11.5 percent in 1965.

(2) Banks with less than $3,250,000 in passbook savings had 13.0 percent of that market in 1961—and dropped to 10.9 percent in 1965.

(3) Banks with less than $1,310,000 in CD and open-book accounts to individuals, partnerships, and corporations had 7.1 percent of that market in 1961 and gained to 11.9 percent of it by June 30, 1965.

These data are now almost a year old and what the statistics for June 30, 1966, would show is partly a matter of conjecture—my conjecture would be the smallest 75 percent of the banks are still holding their own on demand deposits, still losing on passbook savings, and more dependent than ever on the small CD and open-book account to hold their share of the time deposit market.

Mr. Reuss. May I see the copies, now?

The Chairman. The clerk will make them available to you.

Mr. Todd?

Mr. Todd. Thank you, Mr. Chairman.

I very much appreciate the opportunity of clarifying some of my own questions with you gentlemen on the Board. One of my concerns is that as much as we talked about monetary restraint and tight money, I find in the May 1966 Federal Reserve Board Bank of St. Louis Review an article entitled "Monetary Expansion Continues."

Perhaps the point of view can best be expressed by reading one paragraph which is the following: "The interest rate rise since last July has been caused by swelling demands for funds rather than by monetary restrictions. The intensity of the demands for loan funds has been witnessed by very rapid expansion of the bank loans, very large offerings of corporate and municipal securities and substantial increase in governmental debt outstanding as well as by the increase in interest rates."

I have a problem myself in reconciling the statements that are generally made that we are in a period of monetary restriction, and this, which says we are not in a period of monetary restriction. This is borne out to me by expansion of the money supply which has occurred since last year which is on the order of, I believe—depending on what you consider the money supply, some $10 billion, and I just wonder

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how you gentlemen look at this. On the one hand we call it monetary expansion and on the other hand we talk of tight money. Are we talking about the same thing, or is this just a difference of interpretation of policy that we have now?

Mr. ROBERTSON. I think probably it is an application—a mixture of the two, Mr. Todd.

Certainly, the restrictiveness of monetary policy has meant that the money supply and bank credit have expanded more slowly than otherwise would have taken place. We have not attempted to bring to a halt the expansion of credit. But certainly, we have expanded at a slower rate than would have otherwise taken place if we had not been very reluctant in providing reserves.

Mr. TODD. You mean the open market operation; this is really what creates the money supply, is it not?

Mr. ROBERTSON. It depends on how you provide your reserves, either through open market operations, or through the discount window. Either avenue is available for increasing the reserves of the banks. You are right in thinking that most of the reserve expansion is being provided through open market operations.

Mr. TODD. And this has really been an expansion—an expansionary policy, has it not, in that banks have been able to meet loan demands up until recently?

Mr. ROBERTSON. Banks who had——

Mr. TODD. Without many restrictions.

Mr. ROBERTSON. Banks have been able to meet their loan demands, but less readily and with more difficulty and at higher cost since the interest levels were pushed up.

Mr. TODD. I think this particular series of hearings is caused by another aspect of this, and this is the attraction of money from the savings and loans to the banking system, which appears to me to be also a means of expanding the money supply. Savings and loans are not able to create money, but banks increase by 25-fold in the money they attract from the savings and loans. And since I have limited time now, I simply want to suggest that it seems to me we have to make some decisions within 2 weeks, by the middle of June, or we are faced with the prospect of substantial withdrawals from savings and loans moving over into the banking system. Perhaps some sort of liquidity problem for savings and loans. As a consequence, it seems to me we are in the midst of an academic discussion, but we must make some decision quickly on the basis of information available to us.

I wonder how severely you consider the potential liquidity crisis the first of July and if the Board is prepared to move in this? You have mentioned that you are going to do some more studying and I think Mr. Martin has indicated before they were going to study this situation closely, but you can study things so closely you do not act. I do not think there is much prospect of the committee, except via the chairman's resolution, taking action quickly, yet this may be an alternative to inaction by the Board. I wonder what the position of the Board is on this?

Mr. ROBERTSON. I would respond first and the others, I am sure, would be very glad to respond.

First, let me reemphasize that we are as alert to this problem as anyone else could possibly be. The question is the very nature of the problem, the size of the problem, the way in which you should develop

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remedies for it, if it is there and if it is real and not just fear. But, also, I think it must be borne in mind that there are limitations to what you can do with respect to monetary policy to ease the burden here. It may be that what we need to do and what should be done is to deal with this particular problem selectively through either FNMA or the Federal Home Loan Bank Board in order to provide funds, in order to see that the construction industry doesn't bear the whole brunt of the restrictive monetary policy.

On the other hand, if you were to ease monetary policy to the point where the whole interest rate structure would drop down, we would have in my view inflation in this country that no one could stand.

Now, I will let the other members of the Board express their views. Governor Shepardson?

Mr. SHEPARDSON. Mr. Todd, I would agree completely with what Governor Robertson said. We are definitely alert to this problem. We do not consider it something for longtime study. We are fully aware of the possible movement of funds in early July. We are trying to marshal our information to the point that we will be in a position to take constructive action before that time. What that action might be, I think is impossible to determine at this point. I do think that it is important that we recognize this is only one of several areas that we are concerned with. If we were to take steps to lower the availability of funds to banks, which are providing the funds for business, both large and small, we might very well see the problem shift from the present problem of construction and mortgage funds to a problem of small business funds.

A drastic curtailment of the ability of banks to draw in funds to meet the credit needs of business could create a new and different set of problems. We would find small banks and medium-sized banks and their customers being hurt just as well as large banks.

The suggestions that have been made for some limitation on the flow of funds have largely been directed toward the smaller deposits. All the suggestions that I have seen would place limits on the rates paid for the smaller amounts. Well, those are the funds that go to small business, by and large. I think that we have to be very careful that in correcting one problem, we don't create an equally difficult problem in another area. And I would agree with Governor Robertson's suggestion that probably a more satisfactory or more constructive way of meeting this would be through the agencies created to assist in financing homes, perhaps by increasing FNMA's authorization or that of the Home Loan Bank Board.

There was some discussion yesterday about selective controls. Well, it seems to me this is a problem that needs a selective answer through the agencies created to handle this particular area.

Mr. TODD. Thank you. Mr. Chairman, my time has expired.

The CHAIRMAN. We will get back to you, Mr. Todd.

The Board is coming back tomorrow morning to give us all an opportunity to ask further questions.

Mr. Ottinger?

Mr. OTTINGER. Thank you, Mr. Chairman.

I would like to put in the record at this point, if I could, a letter that I have received from the National League of Insured Savings Associations, Harry P. Greep, president, and Rex G. Baker, Jr., vice president, endorsing my bill, H.R. 14422, proposing a floor on time deposits,

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prohibiting issuance in denominations of less than $15,000, but proposing that the limitation should preferably be raised to a minimum denomination of $100,000.

The CHAIRMAN. Without objection, so ordered.

(The letter referred to follows:)

NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS,
Washington, D.C., May 18, 1966.

Hon. RICHARD L. OTTINGER,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN OTTINGER: In connection with the appearance of representatives of the National League of Insured Savings Associations as witnesses before the House of Representatives' Committee on Banking and Currency on May 9 and 10, 1966, you invited an expression of the views of the National League with reference to H.R. 14422, a bill to prohibit insured banks from accepting time deposits in amounts less than $15,000 which you introduced on April 7, 1966.

At its legislative conference in February 1966 in Washington, the National League discussed the topic of certificates of deposit and recommended legislation toward limiting the issuance of negotiable certificates of deposit to a minimum denomination of $100,000. This position was ratified by a special meeting of the members of the National League held on May 3, 1966, at its management conference in White Sulphur Springs, W. Va.

The National League position is based on the theory that certificates of deposit issued by banks should partake of the nature of money market instruments involving substantial blocks of funds, and should not impinge upon the type of deposit normally handled in savings accounts. That position finds support in the action of the Board of Governors of the Federal Reserve System in amending regulation Q in December 1965, since the limit for interest rates on savings accounts was maintained at 4 percent per annum while the limit for interest rates on certificates of deposit and other time deposits was permitted to rise to 5½ percent per annum from a former limit of 4 percent on time deposits of 30 to 89 days and 4½ percent on time deposits of 90 days or more.

Subsequent experience in issuance of certificates of deposit has shown a growing number of examples of their issuance in denominations so small and for terms so short as to attract the attention of investors who otherwise would have probably chosen a savings account in a bank or a similar savings account in a savings and loan association as an investment medium.

Since H.R. 14422 would alleviate this situation by placing a minimum limit of $15,000 on the issuance of nonnegotiable certificates of deposit, the National League supports the principle of the bill. It would prefer to have the minimum placed at a higher figure. It would also urge amendment of the bill to place a minimum limit of $100,000 on the issuance of negotiable certificates of deposit. The principle of fixing express dollar minimum limits should likewise be extended to other types of time deposits in order to prevent their future adaptation to instruments competing with savings accounts.

As noted by its principal witness, Mr. Everett C. Sherbourne, the National League also hopes that action will be taken toward requiring a longer time differential between a savings account and a time deposit, preferably 6 or 9 months.

Sincerely,

HARRY P. GREEP,
President.
REX G. BAKER,
Vice President.

Mr. OTTINGER. You gentlemen of the Federal Reserve Board are very complacent about the effects of your changing regulation Q to permit 5½-percent interest on certificates of deposit and you have said no dire effects have yet been felt. I am sure you are aware that because of the construction cycle it takes some time for these effects to be felt. It will be some 8 or 9 months before the real effects can be felt. The savings and loan people in my area say it is impossible to make new commitments at this time in the mortgage field, and that means that houses that would have been built in the future with this financing will not be started. Construction workers and builders won't be out

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of work, though, until housing financed by current commitments is completed.

Governor Robertson, you say that you disagreed with the action taken in December. I like very much your thinking on what should have been done. Yet you say at this time that you do not think any action is called for to correct the situation that arose against your will from what you consider a bad decision. This disturbs me.

The Chairman of the Home Loan Bank Board, Mr. Horne, has suggested that you be given discretion to set a differential interest rate on the deposits under $10,000. Others have suggested that with respect to the kind of limitation on size that I proposed, you be given discretion. If you were given discretion to put a floor on the size of certificates of deposit, or to put a differential interest rate, would you use it? I would like to hear from you and the Board as to whether your present disposition would be to use it. I know you are against this as a matter of principle.

Mr. ROBERTSON. That would be my reaction, that this would discriminate against the small man in favor of the large man and this goes against the grain as far as I am concerned.

Furthermore, I do not want you to get the impression that I think there is nothing that should be done to meet this problem. I think something should be done, but I want to see the size of the problem and the nature of the problem.

I want to see the size and nature before I act.

Furthermore, one of the reasons I would be disinclined to use this proposal of levels for different rates is that I think there is a much more equitable and much better way of doing this and that is to gear rates to maturities. Now, this is fair from many points of view.

No. 1, the longer a man gives up the use of his funds, the more interest he ought to be permitted to get for them. From the bank point of view, it is in a much better position to schedule its loans and portfolio assets to the maturities the longer it knows it is going to have the funds available. Therefore, I would prefer this sort of program.

Mr. OTTINGER. Do you have the power to do that now?

Mr. ROBERTSON. Absolutely. As a matter of fact, we did it until 1964. In 1964 we moved away from this and then completely away from it in 1965.

Mr. OTTINGER. Then why have you not taken the action?

Mr. ROBERTSON. Well, this is a matter of lack of unanimity of opinion on the subject. I would prefer to let each of my associates speak for themselves.

Mr. OTTINGER. I would like to have them do that. You said that the primary drawout from the savings and loan banks was caused by issuance of what you described as "gimmick certificates," which I take it are nonnegotiable certificates of deposit in small denominations. Does the $17.5 billion in certificates of deposit you cited include these nonnegotiables?

Mr. ROBERTSON. They are the $100,000 and more.

Mr. OTTINGER. Do you know how much is in nonnegotiable certificates of deposit?

Mr. ROBERTSON. I can get the figure on it. This will not be an exact figure because, in the way we figure it, some of the smalltime CD's are in negotiable form, but they are never negotiated and it is not done. But the volume of time——

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Mr. OTTINGER. Would it be possible to get the volume of time deposits under $25,000, $20,000, $15,000, $10,000?

Mr. MITCHELL. You can get time accounts for individuals, partnerships, and corporations with size breaks at $10,000, $10,000 to $25,000, $25,000 to $100,000, and over $100,000. These data are for November 1964, the most recent survey.

Mr. OTTINGER. Is your current survey going to give that information?

Mr. MITCHELL. No. We can give you aggregates in open book and CD's—negotiable and nonnegotiable. For individuals, partnerships, and corporations the total at the end of the year was $35 billion, whereas, passbook savings were $92 billion and State and local government time accounts totaled $12 billion.

Mr. OTTINGER. But you do not have any knowledge as to how much in volume there are in certificates of deposit, negotiable or nonnegotiable, in denominations of $10,000 or less, which Mr. Horne was talking about, or $15,000 or less as reflected in my bill?

Mr. MITCHELL. I do not think so. No; we do not, I am sure.

Mr. OTTINGER. Could you supply such information as you can get on this?

Mr. ROBERTSON. Yes; we will get whatever information we have.

(The information requested follows:)

DISTRIBUTION OF TIME CERTIFICATES OF DEPOSIT BY SIZE OF CERTIFICATE AND SIZE OF BANK

The attached table shows certificates of deposit issued by insured commercial banks classified by size of bank and by size of certificate. The data, which refer to certificates outstanding on April 26, 1965, were provided by the banks in a supplementary statement to the regular report of condition on that date. The data cover both negotiable and nonnegotiable time certificates of deposit, including those sometimes called savings certificates or savings bonds.

Of the $36 billion in total certificates outstanding on the reporting date, more than one-fourth were in denominations of $10,000 or under. Nearly half of the $10.2 billion of certificates in the smallest size classification were issued by banks with less than $10 million in total deposits. At the other end of the size distribution, $13.6 billion—more than one-third of the total—were in certificates with denominations exceeding $500 million, and the bulk of these larger denomination certificates were issued by banks in the largest size class.

The time certificate of deposit is thus not simply a money-market instrument whose issuance is confined to large banks. Rather, it is a type of instrument offered to a wide variety of savers and investors by banks in all size classes.

Time certificates of deposit at insured commercial banks, Apr. 26, 1965, by size of certificate and bank

[Amounts in thousands of dollars]

	All banks	Size of bank (total deposits)			
		Under $10 million	$10–$100 million	$100–$500 million	Over $500 million
Total certificates of deposit	36,041,850	6,898,688	8,299,903	5,201,075	15,642,184
By size:					
$10,000 and under	10,217,617	4,962,422	3,874,851	834,764	545,580
Over $10,000 to $50,000	4,445,881	1,299,466	1,728,496	722,321	695,598
Over $50,000 to $100,000	2,290,200	295,795	765,583	534,236	594,586
Over $100,000 to $250,000	2,525,378	212,188	724,498	629,571	959,121
Over $250,000 to $500,000	2,966,921	93,681	550,631	704,128	1,618,481
Over $500,000 to $1,000,000	7,345,464	28,217	409,773	980,121	5,927,353
Over $1,000,000	6,250,630	7,085	246,132	795,953	5,201,460

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[From the Federal Reserve Bulletin, April 1966, pp. 466–485]

TIME AND SAVINGS DEPOSITS, LATE 1965 AND EARLY 1966

Effective December 6, 1965, the Board of Governors increased to 5½ per cent per annum the maximum interest rate payable by member banks on time deposits. The previous ceiling had been 4 per cent for time deposits with maturities of 30-89 days and 4½ per cent for deposits with longer maturities. There was no change in the 4 per cent rate payable on savings deposits.

To determine the structure of interest-bearing deposits at member banks and the immediate response of banks to the change in the rate ceiling, a survey of time and savings deposits was conducted by the Board of Governors over the year-end. All member banks were asked to report not later than January 3, 1966, interest rates applicable to each major type of deposit held by individuals, partnerships, and corporations (IPC) as of December 3, when the Board's action was taken, and any changes made after that date or definitely planned for the near term. They were also asked to report the dollar amount of each type of deposit outstanding on December 22 and to supply selected information on the characteristics of the different types of deposits they used. Reports were received from virtually all of the 6,220 member banks in existence at the end of 1965.

This article summarizes the results of the survey. The first part of the article relates to the deposit structure at the time of the survey; the second, to the initial rate increases following the change in the ceiling; and the third, to the structure of rates and other characteristics of the deposits.

Since early 1966, some member banks have increased their rates to higher levels than those they had contemplated at the time of the survey. As a result the accompanying tables understate the current level of rates and the increases since December 3. The tables also, of course, do not reflect changes in deposit structure that have occurred since the end of last year.

DEPOSIT STRUCTURE

Historically, savings deposits have made up the bulk of all interest-bearing deposits at member banks. They still do, but in recent years their importance has declined as banks have introduced new instruments designed to counteract specific forms of competition. Since 1961, for example, banks have developed negotiable certificates of deposit (CD's), which are aimed at attracting funds of corporations and other large investors and at halting the movement of demand deposits of these groups from large commercial banks into short-term money market paper. Other new instruments, such as savings certificates and savings bonds, have been aimed at retaining or attracting funds of individuals and other small investors that might flow to other savings institutions or into securities.

Data on the following types of deposits were collected in the survey: savings deposits; savings certificates; savings bonds; other nonnegotiable certificates; negotiable certificates of deposit; and time deposits,

NOTE.—Caroline H. Cagle of the Board's Division of Research and Statistics prepared this article.

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open account. Each of these will be discussed below.

Savings deposits, which may be held only by individuals and certain types of nonprofit organizations, are usually evidenced by a passbook. The bank must reserve the right to require at least 30 days' written notice before withdrawal, but in general practice these deposits may be withdrawn on demand. They are particularly well suited for savers whose deposits are in small amounts or whose needs for withdrawal are irregular and unpredictable. On December 22, 1965, 95 per cent of all member banks had savings deposits, and the amount outstanding was $74.4 billion, as shown in Table 1. At that time they represented 70 per cent of all interest-bearing deposits, IPC, compared with 88 per cent 5 years earlier.

Savings certificates (sometimes called investment certificates), savings bonds, and other nonnegotiable time certificates are all instruments that banks have been promoting in recent years in soliciting more interest-sensitive types of savings and liquid funds from smaller businesses and institutions. These instruments generally state that the bank will pay to the holder on a designated maturity date either (1) the principal amount shown on the instrument plus accrued interest at a specified rate or (2) a specified redemption value, which includes the amount originally deposited plus accrued interest.

TABLE 1

TYPES OF TIME AND SAVINGS DEPOSITS, IPC, HELD BY MEMBER BANKS ON DECEMBER 22, 1965[1]

Type of deposit	Number of banks		Amounts held	
	Reporting specific types	Percentage of all member	In billions of dollars	Percentage distribution
Savings deposits	5,893	95	74.4	70
Savings certificates	2,773	45	6.6	6
Savings bonds	130	2	0.4	(2)
Other nonnegotiable CD's	2,157	35	5.1	5
Negotiable CD's	1,777	29	15.9	15
Time deposits, open account	1,763	28	4.4	4
Total			106.8	100

[1] Time deposits of individuals, partnerships, and corporations.
[2] Less than one-half of 1 per cent.

A distinguishing feature of these and other types of time deposits is that they are not redeemable prior to maturity or until the expiration of a prescribed period of notification of intent to withdraw (not less than 30 days) except in hardship circumstances, and then only at some sacrifice in interest. The instruments are far from standardized, however. Those having the same name may vary in character from bank to bank. And others, though given different designations by different banks, may be identical in character. Certain important characteristics of the various instruments are discussed in the last section of this article.

Of these three types, savings certificates are the largest component. On December 22, 1965, these certificates amounted to $6.6 billion, or 6 per cent of all time and savings deposits, IPC. They were issued by nearly half of the banks, but principally by small institutions. Banks in three Federal Reserve districts—Chicago, St. Louis, and Minneapolis—accounted for almost three-fifths of the total.[1] These instruments have been an important form of time deposits in these Reserve districts for some years. At the time of the survey 6 out of 10 member banks in those districts held some of these deposits.

Savings bonds generally are patterned after the U.S. savings bond and typically are

[1] Appendix Tables I-VI show for savings and the various types of time deposits, the number of banks with such deposits and the amounts of each type of deposit at various levels of interest rates; in these tables the banks are classified by size and by Federal Reserve district.

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redeemable at specified intervals according to the schedule of redemption values shown on the instrument. On December 22 only $422 million of them were outstanding, and they were held by 2 per cent of all the banks surveyed. Banks in all size groups issued them, but a few large banks in the Philadelphia and Atlanta Federal Reserve Districts accounted for the major part of the total.

Other nonnegotiable time certificates totaled $5.1 billion, and they accounted for 5 per cent of all time and savings deposits, IPC. They were used by large and small banks throughout the country, but banks with total deposits of less than $500 million had two-thirds of the total.

Negotiable CD's are evidenced by a document that specifies a principal amount, a maturity, and the rate at which interest will be paid. The distinguishing feature of these instruments, in contrast with those described above, is their negotiability. The bulk of the negotiable CD's outstanding have been issued by large money market banks to national corporations and other large investors in marketable denominations (generally $100,000 and over) at rates competitive with other money market instruments, and a sizable secondary market in these CD's has developed. Some smaller banks also compete for funds of large national corporations, while others issue negotiable CD's in smaller nonmarketable denominations to their local and regional customers.

Less than one-third of all member banks reported that they issue negotiable CD's, but the volume outstanding on December 22 to IPC holders totaled $15.9 billion, the second largest category of IPC deposits. All banks with total deposits of $500 million and over had some of these deposits, and these banks accounted for nearly three-fourths of the total amount outstanding.

Time deposits, open account, generally are evidenced by a written contract specifying the terms and conditions for handling the deposit and the rate of interest to be paid. A special advantage of this type of account is that it can provide for the deposit or withdrawal of funds from time to time without the issuance of separate instruments for each transaction. These deposits, used to a considerable extent for large accounts, can be tailored to the needs of the individual customer, and they show a wider range of usage and characteristics from bank to bank than the other types described. They are also used for special types of small deposits, such as Christmas and vacation clubs, on which many banks pay no interest.

Large banks account for a high proportion of all time deposits, open account. The number of banks that use these deposits is about the same as the number that issue negotiable CD's. However, the volume on December 22, 1965—$4.4 billion—was much smaller than the amount of negotiable CD's outstanding.

RATE INCREASES AFTER DECEMBER 3

The initial changes in maximum rates paid on time deposits, IPC, in late 1965 and early 1966 affected about one-fourth of all member banks. Most of the increases amounted to one-half of a percentage point or less, as shown in Table 2. Nevertheless, the amount of deposits affected (other than savings) was substantial, because most of the banks that raised rates held relatively large amounts of deposits.

As might be expected in view of the interest-sensitive character of the major holders, rate increases were most prevalent on negotiable time certificates of deposit and on time deposits, open account. About four-fifths and two-thirds, respectively, of these

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TABLE 2

NUMBER OF MEMBER BANKS AND AMOUNT OF TIME AND SAVINGS DEPOSITS, IPC, AFFECTED BY INTEREST RATE INCREASES AFTER DECEMBER 3, 1965 [1]

Type of deposit	Number of banks						Amounts in banks raising rates				
	Total increasing rate	Size of rate increase (in percentage points)			Percentage of—		In millions of dollars				Percentage of all member bank holdings
		0.50 or less	0.51–0.99	1.00 and over	All member banks	Banks reporting specific type	Total	Size of rate increase (in percentage points)			
								0.50 or less	0.51–0.99	1.00 and over	
Savings deposits	405	212	4	189	7	7	2,290	1,322	38	929	3
Savings certificates	532	426	7	99	9	19	1,921	1,883	10	28	29
Savings bonds	42	15	....	27	1	32	75	75	....	(2)	18
Other nonnegotiable CD's	470	326	12	132	8	22	2,220	2,127	64	28	43
Negotiable CD's	487	386	15	86	8	27	12,869	12,571	215	83	81
Time deposits, open account	240	171	14	55	4	14	2,888	2,853	14	21	66

[1] As of the survey date, 1,450 banks, or 23 per cent of all member banks, had raised their rate on one or more types of deposits after Dec. 3, 1965. The total amount of time deposits affected by these changes was $22.3 billion, or 21 per cent of all time deposits IPC at member banks. Deposit figures are as of Dec. 22, 1965.

[2] Less than $500,000.

NOTE.—Dollar amounts may not add to totals because of rounding.

deposits were in banks that increased their rates by one-half percentage point or less. Prior to December 6 the banks that held most of these deposits were paying the old 4½ per cent ceiling.

Rate increases affected smaller amounts of savings certificates and bonds and other nonnegotiable certificates, types held mainly by individuals and other small investors. Between one-fifth and one-third of the banks holding these types of deposits changed their maximum rates, and the proportion of all such deposits affected was considerably less than one-half.

The proportion of banks raising their rates and the proportion of other time deposits affected by rate changes were greater for large banks than for smaller ones, as shown in Table 3. Among banks in the largest size group (those with total deposits of $500 million and over), more than four-fifths of all negotiable and nonnegotiable certificates of deposit and time deposits, open account, were in banks that raised their maximum rates. For savings certificates the proportion was nearly half. By contrast, for small banks (total deposits of less than $10 million), the highest proportion of deposits of any type affected by rate increases was one-fifth.

Savings deposits were least influenced by rate increases, in part because there was no increase in the 4 per cent ceiling for these deposits. Only 7 per cent of all member banks had raised their rates on savings by early 1966. Most of these were small institutions in the Middle West and South. For the most part these banks had been paying low rates, and in this move they raised their rates to 3½ or 4 per cent.

STRUCTURE OF RATES AND OTHER CHARACTERISTICS

The survey obtained information on the structure of rates on interest-bearing deposits, as shown in Tables 4-5, and on various characteristics of the major types of time deposits, as shown in Tables 6-8.

Structure of rates. On December 3 nearly three-fourths of all time and savings deposits, IPC, were in banks that were paying ceiling rates. Rates paid were highest for those instruments held mainly by large, rate-

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conscious depositors and lowest for those held principally by small savers.

Nearly all negotiable CD's, savings bonds, and time deposits, open account, were in banks with a 4½ per cent maximum rate on December 3, as shown in Table 4; nevertheless the number of banks at this rate level represented less than one-third of all banks holding negotiable CD's and time deposits, open account. For savings certificates and other nonnegotiable CD's, most of the banks paid no more than 4 per cent, but those banks that had moved their rate up to 4½ per cent on other nonnegotiable CD's held almost half of the deposits.

With respect to savings deposits, 45 per cent of the banks were paying the 4 per cent ceiling on December 3, and these banks accounted for almost four-fifths of all member bank savings deposits. Nearly all of the largest banks were paying the ceiling rate, but this proportion dropped as the size of bank declined—to about two-fifths for banks with total deposits of less than $10 million, as shown in Appendix Table I.

Rates on most forms of other time deposits also varied with the size of bank. When banks are grouped by size of total deposits, the larger the size group, the higher the proportion within the group that were paying the ceiling rate. Most of the time deposits in banks with total deposits of $500 million and over were in those banks with a maximum rate of 4½ per cent on December 3, as shown in Table 5. This proportion dropped to less than one-fourth for banks in the smallest size group. There were two exceptions—savings bonds, on which most banks regardless of size paid 4½ per cent; and savings certificates, on which few banks of any size paid as high as 4½ per cent.

Rates also varied to some extent by geographic areas. They were highest in the San Francisco District where nearly all time and savings deposits were in banks paying the ceiling rate on December 3. At the other extreme, less than 6 per cent of the time and savings deposits (except negotiable CD's and savings bonds) in the Minneapolis Federal Reserve District were in banks paying the ceiling rates.

Reflecting the relatively small number of rate changes after December 3 on savings deposits, the proportion of all member banks paying the 4 per cent ceiling did increase a little—from less than one-half to one-half—by early 1966, but the proportion of all savings deposits that they held re-

TABLE 3

RELATION OF SIZE OF BANK TO RATE INCREASES AT MEMBER BANKS AFTER DECEMBER 3, 1965

(Number and deposits of banks raising rates as percentage of all member banks with specific type of deposit, by size-of-bank group)

Type of deposit	Number of banks						Deposits, December 22, 1965					
	All size groups	Size of bank (total deposits, in millions of dollars)					All size groups	Size of bank (total deposits, in millions of dollars)				
		Less than 10	10–50	50–100	100–500	500 and over		Less than 10	10–50	50–100	100–500	500 and over
Savings deposits	7	6	8	8	7	3	3	6	6	7	4	(1)
Savings certificates	19	16	23	26	32	29	29	17	25	25	43	47
Savings bonds	32	47	30	....	19	25	18	20	8	....	44	13
Other nonnegotiable CD's	22	21	19	24	32	65	43	20	21	20	38	85
Negotiable CD's	27	19	26	32	53	79	81	15	24	30	66	94
Time deposits, open account	14	11	10	13	25	60	66	8	14	13	37	84

[1] Less than one-half of 1 per cent.

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TABLE 4

MAXIMUM RATES PAID ON VARIOUS FORMS OF TIME AND SAVINGS DEPOSITS, IPC, OF MEMBER BANKS ON DECEMBER 3, 1965, AND IN EARLY 1966 [1]

(Percentage distribution within type-of-deposit grouping)

Type of deposit	In effect on December 3, 1965						In effect in early 1966					
	All rates	Maximum rate (per cent) [2]					All rates	Maximum rate (per cent) [2]				
		4.50	4.25	4.00	3.50	3.00 or less		5.50	5.00	4.50	4.00	3.50 or less
	Number of banks											
Savings deposits	100	....	....	45	15	40	100	....	....	....	50	50
Savings certificates	100	14	4	76	2	4	100	([3])	2	31	62	5
Savings bonds	100	58	8	34	....	....	100	1	5	68	25	1
Other nonnegotiable CD's	100	19	6	64	4	7	100	([3])	5	32	53	9
Negotiable CD's	100	30	8	55	2	5	100	([3])	12	36	46	6
Time deposits, open account	100	13	5	36	18	28	100	([3])	5	16	35	43
	Amount of deposits											
Savings deposits	100	....	....	79	11	10	100	....	....	....	81	19
Savings certificates	100	16	11	72	1	([3])	100	([3])	4	43	52	1
Savings bonds	100	95	2	3	....	....	100	([3])	17	80	3	([3])
Other nonnegotiable CD's	100	47	10	42	([3])	1	100	([3])	30	36	33	1
Negotiable CD's	100	84	6	10	([3])	([3])	100	([3])	77	15	7	([3])
Time deposits, open account	100	74	8	13	2	3	100	([3])	60	23	12	5

[1] Time and savings deposits held on Dec. 22, 1965. Excludes banks that reported no interest rate paid.
[2] The maximum rate applies to maturities of 1 year or more where available. When a bank did not report a rate for this maturity, the rate for the next shorter maturity was used.
[3] Less than one-half of 1 per cent.

TABLE 5

BANKS PAYING OLD 4½% CEILING RATE ON TIME DEPOSITS, IPC, ON DECEMBER 3, 1965, AND BANKS PAYING OVER 4½% IN EARLY 1966

(Percentage of all member banks with specific type of deposit, by size-of-bank group)

Type of deposit	December 3, 1965—Maximum rate: 4½ per cent						Early 1966—Maximum rate: Over 4½ per cent					
	All size groups	Size of bank (total deposits, in millions of dollars)					All size groups	Size of bank (total deposits, in millions of dollars)				
		Less than 10	10–50	50–100	100–500	500 and over		Less than 10	10–50	50–100	100–500	500 and over
	Number of banks											
Savings certificates	14	12	16	22	24	23	2	2	3	6	4	4
Savings bonds	58	50	54	67	65	80	6	9	2	....	10	8
Other nonnegotiable CD's	19	16	17	26	36	67	6	4	4	5	17	47
Negotiable CD's	30	23	25	32	52	91	13	7	8	8	34	75
Time deposits, open account	13	8	8	25	25	72	5	3	3	2	14	51
	Amount of deposits, December 22, 1965											
Savings certificates	16	10	15	25	22	12	4	2	2	5	3	10
Savings bonds	95	60	72	83	92	98	17	([1])	([1])	....	41	13
Other nonnegotiable CD's	47	16	24	35	46	84	30	3	7	6	17	78
Negotiable CD's	84	24	34	41	65	97	77	5	9	10	54	94
Time deposits, open account	74	18	19	34	41	92	60	3	9	3	20	81

[1] Less than one-half of 1 per cent.

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mained about unchanged at four-fifths, as shown in Table 4.

Few banks raised the rate on any type of time deposits above 5 per cent in the period covered by the survey. On savings certificates and savings bonds most of the rate adjustments pushed the maximum rate paid to 4½ per cent; few banks raised their rates above this level. By early 1966, two-fifths of all savings certificates and four-fifths of all savings bonds were in banks paying a rate of 4½ per cent. Because most large banks that hold the bulk of negotiable CD's and time deposits, open account, and a substantial volume of other nonnegotiable CD's adjusted their maximum rate upward to 4¾ or 5 per cent after December 3, nearly all of these deposits in the largest bank-size group (total deposits of $500 million and over) were in banks paying over 4½ per cent by early 1966, as shown in Table 5. Among smaller banks relatively few had raised their rate on any form of time deposit above 4½ per cent in the period covered by the survey.

Other characteristics. For each of the major types of time deposits issued by banks on December 3, the survey requested information as to the minimum deposit required and the minimum and the maximum maturity; whether the agreement included a provision for automatic renewal or an option to redeem prior to maturity; and whether the instrument was issued only to individuals and nonprofit associations.

Some instruments—even though they are designed for relatively small savers—require larger minimum deposits than apply to passbook savings accounts. The minimum de-

TABLE 6

MINIMUM DEPOSIT ACCEPTED ON VARIOUS FORMS OF TIME DEPOSITS, IPC, ON DECEMBER 3, 1965

(Percentage distribution of the number of banks in each size-of-bank group)

Type of deposit, and size of bank (total deposits, in millions of dollars)	All banks with deposits	Minimum deposit accepted (in dollars)							
		Under 100	100–499	500–999	1,000–4,999	5,000–9,999	10,000–99,999	100,000 and over	No information
Savings certificates:									
All size groups	100	12	32	24	14	1	(1)	(1)	16
Under 100	100	13	32	25	13	1	(1)	(1)	16
100 – 500	100	9	36	23	16	3	....	1	12
500 and over	100	9	37	14	26	9	2	....	3
Savings bonds:									
All size groups	100	68	7	12	8	....	....	....	5
Under 100	100	69	5	12	7	....	....	....	7
100 – 500	100	65	10	10	10	....	....	....	5
500 and over	100	70	10	10	10	....	....	....	....
Other nonnegotiable CD's:									
All size groups	100	11	18	19	22	3	4	(1)	23
Under 100	100	11	19	20	22	2	3	(1)	23
100 – 500	100	5	11	15	33	8	11	....	17
500 and over	100	3	5	8	20	15	18	13	18
Negotiable CD's:									
All size groups	100	11	17	16	22	3	5	4	22
Under 100	100	13	18	18	23	2	3	1	22
100 – 500	100	5	8	11	19	7	17	11	22
500 and over	100	....	3	8	11	3	21	42	12
Time deposits, open account:									
All size groups	100	10	5	5	14	3	8	2	53
Under 100	100	11	5	6	13	3	6	1	55
100 – 500	100	6	5	3	18	7	22	5	34
500 and over	100	....	....	5	18	7	19	12	39

[1] Less than one-half of 1 per cent.

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TABLE 7

MINIMUM AND MAXIMUM MATURITIES ON VARIOUS FORMS OF TIME DEPOSITS, IPC, ON DECEMBER 3, 1965

(Percentage distribution of number of banks in each size-of-bank group)

Type of deposit, and size of bank (total deposits, in millions of dollars)	All maturities	Minimum maturity (months)					Maximum maturity (months)				
		3 or less	4–6	7–12	Over 12	No information	6 or less	7–12	13–60	Over 60	No information
Savings certificates:											
All size groups	100	42	33	23	(1)	1	3	86	10	1	(1)
Under 100	100	41	34	23	(1)	1	3	87	9	1	(1)
100–500	100	52	25	20	1	2	7	73	20	....	....
500 and over	100	47	26	21	2	4	14	51	33	2	....
Savings bonds:											
All size groups	100	62	12	9	12	5	1	12	86	1	....
Under 100	100	60	15	14	8	3	1	16	82	1	....
100–500	100	55	5	....	30	10	....	5	95	....	....
500 and over	100	90	....	....	....	10	....	....	100	....	....
Other nonnegotiable CD's:											
All size groups	100	53	29	17	(1)	1	5	85	9	1	....
Under 100	100	50	30	18	(1)	1	5	86	8	1	....
100–500	100	81	12	5	2	....	3	73	24	(1)	....
500 and over	100	79	13	8	....	....	3	67	28	2	....
Negotiable CD's:											
All size groups	100	66	22	11	(1)	1	3	84	12	1	....
Under 100	100	61	25	13	(1)	1	3	86	10	1	....
100–500	100	95	4	1	....	....	2	74	23	1	....
500 and over	100	93	7	....	....	....	1	67	31	1	....
Time deposits, open account:											
All size groups	100	61	28	8	(1)	3	17	72	8	1	2
Under 100	100	59	29	8	(1)	3	17	72	7	1	3
100–500	100	78	14	8	....	....	16	72	11	1	....
500 and over	100	94	5	1	....	....	1	78	21	....	....

[1] Less than one-half of 1 per cent.

posit required by the largest number of banks, regardless of size, was less than $100 for savings bonds and less than $500 for savings certificates, as shown in Table 6. Nearly half of the banks with savings bonds and one-fourth of those with savings certificates restricted the use of these instruments to individuals and nonprofit associations—higher proportions than for other forms of time deposits. This restriction was more common for large than for small banks.

Most banks reported that savings bonds included an option for redemption prior to maturity and that savings certificates contained a provision for automatic renewal at maturity. The latter was more common for small than for large banks, as shown in Table 8. The largest number of banks indicated that the usual minimum maturity was 3 months or less on both instruments, while the maximum maturity was generally 7-12 months for savings certificates and up to 5 years for saving bonds. (See Table 7.)

The characteristics of other nonnegotiable certificates of deposits varied with the size of bank. In the smaller banks (total deposits of less than $100 million) about half of the banks had minimum deposit requirements of less than $1,000, whereas for the largest banks (total deposits of $500 million and over) about a third reported that the minimum was $10,000 or over. As for savings certificates, the most common minimum maturity was 3 months or less, and maximum maturity was 7-12 months. Few banks indicated these instruments were restricted to individuals and nonprofit associations, and only one-third of the banks

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TABLE 8

RENEWAL, REDEMPTION, AND ELIGIBILITY CHARACTERISTICS OF VARIOUS FORMS OF TIME DEPOSITS, IPC, DECEMBER 3, 1965

(Percentage distribution of number of banks in each size-of-bank group)

Type of deposit, and size of bank (total deposits, in millions of dollars)	All banks with deposits	Special renewal and redemption provisions				Eligibility	
		Automatic renewal	Redemption option prior to maturity	Combination automatic renewal and redemption option prior to maturity	None specified	Issued to individuals and non-profit institutions only	No restrictions specified
Savings certificates:							
All size groups	100	51	7	13	29	23	77
Under 10	100	49	6	11	34	22	78
10 – 50	100	54	7	17	22	19	81
50 – 100	100	69	2	13	16	25	75
100 – 500	100	44	10	17	29	36	64
500 and over	100	30	16	23	31	70	30
Savings bonds:							
All size groups	100	14	60	11	15	44	56
Under 10	100	13	53	13	21	30	70
10 – 50	100	22	49	8	21	35	65
50 – 100	100	0	67	17	16	33	67
100 – 500	100	5	80	10	5	60	40
500 and over	100	10	80	10	....	90	10
Other nonnegotiable CD's:							
All size groups	100	33	7	8	52	14	86
Under 10	100	32	9	8	51	18	82
10 – 50	100	34	7	9	50	9	91
50 – 100	100	42	4	5	49	7	93
100 – 500	100	28	4	10	58	9	91
500 and over	100	21	5	8	66	10	90
Negotiable CD's:							
All size groups	100	15	8	5	72	11	89
Under 10	100	17	10	3	70	17	83
10 – 50	100	16	7	5	72	7	93
50 – 100	100	14	3	6	77	2	98
100 – 500	100	9	9	7	75	2	98
500 and over	100	3	3	5	89	3	97
Time deposits, open account:							
All size groups	100	20	8	8	64	9	91
Under 10	100	23	7	8	62	10	90
10 – 50	100	21	9	7	63	9	91
50 – 100	100	17	6	12	65	6	94
100 – 500	100	1[illegible]	13	6	71	11	89
500 and over	100	[illegible]	7	25	64	5	95

reported they contained a provision for automatic renewal at maturity.

Negotiable CD's and time deposits, open account, carry substantial minimum deposit requirements. In banks with total deposits of $500 million and over, where the bulk of these deposits are held, the largest number of banks reported the minimum requirement on negotiable CD's was $100,000 or more and on time deposits, open account, it was $10,000 and over. The minimum maturity most frequently reported was 3 months or less, and the maximum maturity, 7-12 months. The largest banks almost never restricted these instruments to individuals and nonprofit associations, and relatively few of the instruments include a provision for automatic renewal or an option for redemption prior to maturity. For smaller banks that held instruments of this type, the minimum deposit requirement was lower—generally less than $5,000 for banks with total deposits of under $100 million. Some banks of this size included in the agreement a provision for automatic renewal or an option to redeem prior to maturity.

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APPENDIX

TABLE I

SAVINGS DEPOSITS: MAXIMUM INTEREST RATES PAID BY MEMBER BANKS, DECEMBER 3, 1965, AND EARLY 1966 [1]

Group	All member banks (June 30, 1965)	All survey banks with deposits														
		Total	Maximum rate [2] paid, early 1966 (per cent)			Banks raising rates after Dec. 3, 1965							Banks not raising rates			
			4	3½	3 or less	Total	Maximum rate [2] paid, early 1966 (per cent)			Maximum rate [2] paid, Dec. 3, 1965 (per cent)			Total	Maximum rate [2] paid, Dec. 3, 1965 (per cent)		
							4	3½	3 or less	3½	3 or less	No rate		4	3½	3 or less
	Number of banks															
All member banks	**6,235**	**5,893**	**2,946**	**855**	**2,092**	**405**	**284**	**87**	**34**	**124**	**273**	**8**	**5,488**	**2,662**	**768**	**2,058**
Size of bank (total deposits, in millions of dollars):																
Less than 10	3,902	3,593	1,565	510	1,518	233	141	66	26	68	157	8	3,360	1,424	444	1,492
10–50	1,756	1,730	948	271	511	134	111	16	7	38	96	......	1,596	837	255	504
50–100	243	241	164	40	37	19	16	3	......	10	9	......	222	148	37	37
100–500	259	254	204	26	24	17	14	2	1	8	9	......	237	190	24	23
500 and over	75	75	65	8	2	2	2	......	......	......	2	......	73	63	8	2
Federal Reserve district:																
Boston	250	227	169	11	47	17	17	......	......	5	12	......	210	152	11	47
New York	411	401	311	57	33	20	20	......	......	18	2	......	381	291	57	33
Philadelphia	411	395	65	129	201	54	22	28	4	22	32	......	341	43	101	197
Cleveland	504	492	208	72	212	15	14	1	......	1	14	......	477	194	71	212
Richmond	414	406	256	68	82	17	9	6	2	4	13	......	389	247	62	80
Atlanta	511	515	333	82	100	51	45	5	1	21	30	......	464	288	77	99
Chicago	1,017	972	311	198	463	21	16	4	1	4	17	......	951	295	194	462
St. Louis	486	448	88	99	261	51	26	12	13	21	29	1	397	62	87	248
Minneapolis	495	489	81	36	372	81	58	14	9	2	79	......	408	23	22	363
Kansas City	834	781	431	74	276	52	32	16	4	7	41	4	729	399	58	272
Dallas	677	544	472	27	45	22	21	1	......	15	4	3	522	451	26	45
San Francisco	225	223	221	2	......	4	4	......	......	4	......	......	219	217	2	......
	Amounts (in millions of dollars)															
All member banks		**74,422**	**60,644**	**7,250**	**6,528**	**2,290**	**1,930**	**308**	**52**	**1,046**	**1,244**	......	**72,132**	**58,714**	**6,942**	**6,476**
Size of bank (total deposits, in millions of dollars):																
Less than 10		5,461	2,810	981	1,670	336	191	125	20	119	217	......	5,125	2,619	856	1,650
10–50		12,741	7,922	2,013	2,806	784	668	85	31	272	512	......	11,957	7,254	1,928	2,775
50–100		5,993	4,229	1,010	754	436	390	46	......	292	143	......	5,557	3,839	964	754
100–500		16,817	14,181	1,519	1,117	627	574	52	1	363	264	......	16,190	13,607	1,467	1,116
500 and over		33,410	31,502	1,727	181	108	108	......	......	......	108	......	33,303	31,394	1,727	181
Federal Reserve district:																
Boston		2,421	2,164	45	212	137	137	......	......	63	74	......	2,284	2,027	45	212
New York		14,393	12,814	771	809	300	300	......	......	227	73	......	14,093	12,513	771	809
Philadelphia		3,810	1,587	1,117	1,106	358	208	146	4	208	150	......	3,452	1,379	971	1,102
Cleveland		6,972	4,471	1,832	669	168	142	26	......	2	165	......	6,804	4,329	1,807	669
Richmond		3,769	2,849	660	260	145	125	19	2	106	39	......	3,623	2,724	641	257
Atlanta		3,768	2,893	643	232	297	284	11	2	201	96	......	3,471	2,610	632	229
Chicago		14,081	10,793	1,690	1,598	180	151	25	4	59	121	......	13,901	10,642	1,665	1,594
St. Louis		1,702	770	270	661	162	81	52	29	77	85	......	1,540	690	218	632
Minneapolis		1,159	399	88	672	364	332	23	10	1	364	......	795	68	65	663
Kansas City		2,590	2,222	94	274	81	74	6	1	10	71	......	2,509	2,148	88	273
Dallas		2,778	2,710	31	36	44	44	(3)	......	40	5	......	2,734	2,666	31	36
San Francisco		16,979	16,970	8	......	52	52	......	......	52	......	......	16,926	16,918	8	......

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a maximum rate in between those shown, it was included in the group paying the next higher rate.

[3] Less than $500,000.

NOTE.—Figures may not add to totals because of rounding.

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TABLE II

SAVINGS CERTIFICATES, IPC: MAXIMUM INTEREST RATES PAID BY MEMBER BANKS, DECEMBER 3, 1965, AND EARLY 1966

Group	All survey banks with deposits[1]	Maximum rate paid,[2] early 1966 (per cent)					Banks raising rates after Dec. 3, 1965									Banks not raising rates			
							Total	Maximum rate paid,[2] early 1966 (per cent)				Maximum rate paid,[2] Dec. 3, 1965 (per cent)				Total	Maximum rate paid,[2] Dec. 3, 1965 (per cent)		
		5.5	5.0	4.5	4.0	3.5 or less		5.5	5.0	4.5	4.0 or less	4.5	4.0	3.5 or less	No rate		4.5	4.0	3.5 or less
	Number of banks																		
All member banks	2,773	6	60	852	1,715	140	532	6	60	429	37	77	352	28	75	2,241	423	1,680	138
Size of bank (total deposits, *in millions of dollars*):																			
Less than 10	1,747	2	31	452	1,165	97	283	2	31	227	23	34	191	19	39	1,464	225	1,144	95
10–50	772	2	19	274	447	30	175	2	19	144	10	23	125	6	21	597	130	437	30
50–100	95	1	5	38	50	1	25	1	5	17	2	6	11	1	7	70	21	48	1
100–500	114	1	3	60	40	10	36	1	3	30	2	6	22	2	6	78	30	38	10
500 or over	45	....	2	28	13	2	13	....	2	11	....	8	3	....	2	32	17	13	2
F.R. district:																			
Boston	28	....	2	9	14	3	6	....	2	4	....	1	1	....	4	22	5	14	3
New York	75	....	4	27	39	5	17	....	4	10	3	8	....	1	8	58	17	36	5
Philadelphia	158	....	....	44	94	20	23	....	....	21	2	....	15	5	3	135	23	92	20
Cleveland	298	....	3	32	248	15	13	....	3	8	2	4	7	2	....	285	24	246	15
Richmond	151	....	2	61	76	12	25	....	2	20	3	1	16	2	6	126	41	73	12
Atlanta	269	....	2	135	119	13	37	....	2	31	4	4	25	6	2	232	104	115	13
Chicago	571	1	1	95	451	23	62	1	1	53	7	3	43	3	13	509	42	444	23
St. Louis	212	....	5	91	105	11	82	....	5	76	1	7	65	2	8	130	15	104	11
Minneapolis	414	....	2	117	286	9	115	....	2	111	2	2	106	2	5	299	6	284	9
Kansas City	330	....	13	127	173	17	89	....	13	71	5	19	57	3	10	241	56	168	17
Dallas	157	....	8	54	89	6	25	....	8	12	5	....	15	2	8	132	42	84	6
San Francisco	110	5	18	60	21	6	38	5	18	12	3	28	2	....	8	72	48	20	4

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	Amounts (in millions of dollars)																		
All member banks	6,560	9	234	2,816	3,413	88	1,921	9	234	1,667	11	585	1,319	16	....	4,639	1,149	3,402	88
Size of bank (total deposits in millions of dollars):																			
Less than 10	1,595	(3)	24	436	1,106	28	279	(3)	24	252	3	22	252	5	....	1,316	184	1,103	28
10–50	2,255	(3)	40	872	1,309	35	553	(3)	40	510	3	62	485	5	....	1,703	362	1,306	35
50–100	669	(3)	35	289	343	3	170	(3)	35	130	5	57	108	5	....	500	159	338	3
100–500	1,008	9	26	650	300	23	431	9	26	395	1	69	362	1	....	576	255	299	22
500 or over	1,033	....	108	568	357	1	488	....	108	380	....	376	112	....	....	545	188	357	1
F.R. district:																			
Boston	17	....	(3)	1	15	(3)	(3)	....	(3)	(3)	....	(3)	(3)	....	....	17	1	15	(3)
New York	341	....	10	270	61	(3)	221	....	10	211	1	220	....	1	....	119	59	60	(3)
Philadelphia	342	....	....	130	186	26	33	....	....	33	(3)	....	32	1	....	309	97	186	26
Cleveland	592	....	41	81	463	6	56	....	41	13	1	45	10	1	....	536	68	462	6
Richmond	234	....	1	153	67	12	34	....	1	32	1	1	33	1	....	200	121	66	12
Atlanta	542	....	2	357	180	3	79	....	2	72	5	9	65	5	....	463	285	175	3
Chicago	1,614	9	....	360	1,224	21	215	9	....	206	(3)	16	198	(3)	....	1,400	154	1,224	21
St. Louis	628	....	130	276	219	3	376	....	130	245	1	170	205	1	....	252	31	218	3
Minneapolis	1,399	....	3	605	783	8	588	....	3	585	....	15	569	4	....	811	20	783	8
Kansas City	399	....	17	240	139	2	202	....	17	184	1	26	175	1	....	197	56	138	2
Dallas	132	....	12	75	44	2	26	....	12	14	1	....	26	1	....	105	61	43	2
San Francisco	322	(3)	18	267	32	5	90	(3)	18	72	....	83	7	....	....	232	195	32	5

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a maximum rate in between those shown, it was included in the group paying the next higher rate. In most cases the maximum rate is that applicable to maturities of 1 year or more. When a rate for this maturity was not reported, the rate applicable to the next shorter maturity was used.

[3] Less than $500,000.

NOTE.—Figures may not add to totals because of rounding.

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TABLE III

SAVINGS BONDS, IPC: MAXIMUM INTEREST RATES PAID BY MEMBER BANKS, DECEMBER 3, 1965, AND EARLY 1966

Group	All survey banks with deposits[1]	Maximum rate paid,[2] early 1966 (per cent)					Banks raising rates after Dec. 3, 1965									Banks not raising rates			
							Total	Maximum rate paid,[2] early 1966 (per cent)				Maximum rate paid,[2] Dec. 3, 1965 (per cent)				Total	Maximum rate paid[2] Dec. 3, 1965 (per cent)		
		5.5	5.0	4.5	4.0	3.5 or less		5.5	5.0	4.5	4.0 or less	4.5	4.0	3.5 or less	No rate		4.5	4.0	3.5 or less
	Number of banks																		
All member banks	130	1	7	89	32	1	42	1	7	30	4	8	7	....	27	88	59	29	....
Size of bank (total deposits in millions of dollars):																			
Less than 10	45	1	3	29	11	1	21	1	3	16	1	4	2	....	15	24	13	11	....
10–50	46	....	1	33	12	....	14	....	1	11	2	2	3	....	9	32	22	10	....
50–100	6	....	....	4	2	....	....	....	....	....	....	....	....	....	....	6	4	2	....
100–500	21	....	2	14	5	....	4	....	2	2	....	1	2	....	1	17	12	5	....
500 and over	12	....	1	9	2	....	3	....	1	1	1	1	....	....	2	9	8	1	....
F.R. district:																			
Boston	5	....	1	4	....	....	4	....	1	3	....	....	....	....	4	1	1	....	....
New York	11	....	2	6	3	....	4	....	2	2	....	1	....	....	3	7	4	3	....
Philadelphia	9	....	....	9	....	....	....	....	....	....	....	....	....	....	....	9	9	....	....
Cleveland	8	....	....	7	1	....	2	....	....	1	1	....	....	....	2	6	6	....	....
Richmond	13	....	2	9	2	....	4	....	2	2	....	1	....	....	3	9	7	2	....
Atlanta	28	....	1	19	8	....	15	....	1	12	2	5	5	....	5	13	7	6	....
Chicago	13	....	....	8	5	....	1	....	....	1	....	....	1	....	....	12	7	5	....
St. Louis	16	....	1	5	10	....	3	....	1	2	....	....	....	....	3	13	3	10	....
Minneapolis	4	....	....	4	....	....	2	....	....	2	....	....	....	....	2	2	2	....	....
Kansas City	15	....	....	12	2	1	5	....	....	4	1	....	1	....	4	10	8	2	....
Dallas	4	....	....	3	1	....	1	....	....	1	....	....	....	....	1	3	2	1	....
San Francisco	4	1	....	3	....	....	1	1	....	....	....	1	....	....	....	3	3	....	....

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	Amounts (in millions of dollars)																		
All member banks	422	(3)	71	340	11	(3)	75	(3)	71	4	(3)	72	3	......	......	346	335	11	......
Size of bank (total deposits in millions of dollars):																			
Less than 10	5	(3)	(3)	3	2	(3)	1	(3)	(3)	(3)	(3)	1	(3)	......	......	5	3	2	......
10–50	25	......	(3)	20	5	......	2	......	(3)	2	(3)	1	(3)	......	......	23	18	5	......
50–100	6	......	......	5	1	......	......	......	......	......	......	......	......	......	......	6	5	1	......
100–500	73	......	30	39	3	......	32	......	30	2	......	30	2	......	......	40	37	3	......
500 and over	313	......	41	272	(3)	......	41	......	41	(3)	(3)	41	......	......	......	272	272	(3)	......
F.R. district:																			
Boston	4	......	(3)	4	......	......	(3)	......	(3)	(3)	......	......	......	......	......	4	4	......	......
New York	65	......	41	24	(3)	......	41	......	41	(3)	......	41	......	......	......	25	24	(3)	......
Philadelphia	121	......	......	121	......	......	......	......	......	......	......	......	......	......	......	121	121	......	......
Cleveland	5	......	......	5	(3)	......	(3)	......	......	(3)	(3)	......	......	......	......	5	5	......	......
Richmond	32	......	30	2	(3)	......	30	......	30	(3)	......	30	......	......	......	2	2	(3)	......
Atlanta	161	......	(3)	157	3	......	4	......	(3)	4	(3)	2	2	......	......	156	153	3	......
Chicago	13	......	......	11	2	......	(3)	......	......	(3)	......	......	(3)	......	......	13	11	2	......
St. Louis	5	......	(3)	(3)	4	......	(3)	......	(3)	(3)	......	......	......	......	......	5	(3)	4	......
Minneapolis	1	......	......	1	......	......	(3)	......	......	(3)	......	......	......	......	......	1	1	......	......
Kansas City	13	......	......	13	(3)	(3)	(3)	......	......	(3)	(3)	......	(3)	......	......	13	13	(3)	......
Dallas	(3)	......	......	(3)	(3)	......	(3)	......	......	(3)	......	......	......	......	......	(3)	(3)	(3)	......
San Francisco	2	(3)	......	2	......	......	(3)	(3)	......	......	......	(3)	......	......	......	2	2	......	......

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a rate in between those shown, it was included in the group paying the next higher rate. In most cases the maximum rate is that applicable to maturities of 1 year or more. When a rate for this maturity was not reported, the rate applicable to the next shorter maturity was used.

[3] Less than $500,000.

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TABLE IV

OTHER NONNEGOTIABLE CD'S, IPC: MAXIMUM INTEREST RATES PAID BY MEMBER BANKS, DECEMBER 3, 1965, AND EARLY 1966

Group	All survey banks with deposits[1]	Maximum rate paid,[2] early 1966 (per cent)					Banks raising rates after Dec. 3, 1965									Banks not raising rates			
							Total	Maximum rate paid,[2] early 1966 (per cent)				Maximum rate paid,[2] Dec. 3, 1965 (per cent)				Total	Maximum rate paid, Dec. 3, 1965 (per cent)		
		5.5	5.0	4.5	4.0	3.5 or less		5.5	5.0	4.5	4.0 or less	4.5	4.0	3.5 or less	No rate		4.5	4.0	3.5 or less
	Number of banks																		
All member banks	2,157	6	114	698	1,147	192	470	6	114	302	48	116	218	40	96	1,687	396	1,103	188
Size of bank (total deposits, in millions of dollars):																			
Less than 10	1,191	4	44	361	657	125	245	4	44	165	32	42	120	27	56	946	196	628	122
10–50	680	2	24	211	388	55	129	2	24	89	14	23	71	12	23	551	122	374	55
50–100	127	......	6	54	60	7	31	......	6	23	2	8	17	1	5	96	31	59	6
100–500	116	......	20	52	39	5	37	......	20	17	......	19	10	......	8	79	35	39	5
500 and over	43	......	20	20	3	......	28	......	20	8	......	24	......	......	4	15	12	3	......
Federal Reserve district:																			
Boston	66	......	8	22	30	6	15	......	8	6	1	9	4	1	1	51	16	29	6
New York	178	......	15	64	81	18	44	......	15	23	6	14	14	6	10	134	41	75	18
Philadelphia	155	......	4	48	83	20	34	......	4	28	2	3	18	6	7	121	20	82	19
Cleveland	142	......	4	30	91	17	14	......	4	6	4	2	5	3	4	128	24	87	17
Richmond	138	2	8	62	54	12	34	2	8	20	4	6	11	5	12	104	42	51	11
Atlanta	213	1	2	104	83	23	40	1	2	35	2	9	22	2	7	173	69	82	22
Chicago	357	......	11	57	256	33	51	......	11	29	11	11	18	4	18	306	28	245	33
St. Louis	198	......	4	53	125	16	47	......	4	39	4	7	31	4	5	151	14	121	16
Minneapolis	105	......	1	23	74	7	23	......	1	21	1	......	19	1	3	82	2	73	7
Kansas City	269	1	7	104	132	25	76	1	7	62	6	9	48	5	14	193	42	126	25
Dallas	243	......	16	84	129	14	46	......	16	24	6	8	27	2	9	197	60	123	14
San Francisco	93	2	34	47	9	1	46	2	34	9	1	38	1	1	6	47	38	9	......

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	Amounts (in millions of dollars)																		
All member banks	5,110	11	1,521	1,833	1,699	46	2,220	11	1,521	684	4	1,758	452	9	1	2,890	1,149	1,695	46
Size of bank (total deposits, in millions of dollars):																			
Less than 10	778	(3)	26	252	482	19	153	(3)	26	124	2	40	109	4	(3)	625	127	479	19
10-50	1,286	11	82	459	718	16	270	11	82	176	1	103	162	5	(3)	1,015	282	717	16
50-100	568	....	32	275	256	5	111	....	32	79	(3)	51	59	(3)	....	458	196	256	5
100-500	891	....	149	504	231	6	340	....	149	191	....	219	121	....	(3)	550	313	231	6
500 and over	1,587	....	1,232	344	11	....	1,345	....	1,232	113	....	1,345	....	....	....	242	231	11	....
Federal Reserve district:																			
Boston	38	....	7	12	18	(3)	10	....	7	3	(3)	9	1	(3)	....	28	9	18	(3)
New York	548	....	218	262	65	2	317	....	218	98	1	266	49	2	....	231	165	64	2
Philadelphia	278	....	9	90	171	7	44	....	9	35	(3)	8	34	2	(3)	234	56	171	7
Cleveland	373	....	140	108	122	2	168	....	140	27	(3)	146	22	(3)	....	205	81	122	2
Richmond	223	3	79	86	52	2	109	3	79	26	(3)	97	11	(3)	....	114	60	52	2
Atlanta	511	8	39	335	121	8	164	8	39	117	....	131	32	1	(3)	347	218	121	8
Chicago	896	....	32	326	530	7	114	....	32	82	(3)	69	43	2	....	782	245	530	7
St. Louis	446	....	27	142	269	8	128	....	27	101	1	51	76	1	(3)	318	41	268	8
Minneapolis	170	....	1	47	118	4	41	....	1	40	(3)	....	41	(3)	....	129	7	118	4
Kansas City	327	(3)	27	170	126	3	114	(3)	27	86	1	29	84	1	....	213	85	125	3
Dallas	269	....	51	116	100	2	88	....	51	38	....	30	58	(3)	....	180	79	100	2
San Francisco	1,032	(3)	890	136	5	....	923	(3)	890	32	....	922	1	(3)	....	109	104	5	....

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a maximum rate in between those shown, it was included in the group paying the next higher rate. In most cases the maximum rate is that applicable to maturities of 1 year or more. When a rate for this maturity was not reported, the rate applicable to the next shorter maturity was used.

[3] Less than $500,000.

NOTE.—Figures may not add to totals because of rounding.

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Table V

Negotiable CD's, IPC: Maximum Interest Rates Paid by Member Banks on December 3, 1965, and Early 1966

Group	All survey banks with deposits[1]	Maximum rate paid,[2] early 1966 (per cent)					Banks raising rates after Dec. 3, 1965									Banks not raising rates			
							Total	Maximum rate paid,[2] early 1966 (per cent)				Maximum rate paid,[2] Dec. 3, 1965 (per cent)				Total	Maximum rate paid,[2] Dec. 3, 1965 (per cent)		
		5.5	5.0	4.5	4.0	3.5 or less		5.5	5.0	4.5	4.0 or less	4.5	4.0	3.5 or less	No rate		4.5	4.0	3.5 or less
	Number of banks																		
All member banks	1,777	5	223	632	814	103	487	5	223	231	28	245	151	19	72	1,290	401	790	99
Size of bank (total deposits, in millions of dollars):																			
Less than 10	882	4	60	261	483	74	164	4	60	86	14	58	54	8	44	718	175	472	71
10–50	543	....	42	211	264	26	140	....	42	89	9	47	63	7	23	403	122	255	26
50–100	107	....	9	58	38	2	34	....	9	21	4	15	12	3	4	73	37	35	1
100–500	170	....	57	83	29	1	90	....	57	32	1	66	22	1	1	80	51	28	1
500 and over	75	1	55	19	....	....	59	1	55	3	....	59	....	....	....	16	16	....	....
Federal Reserve district:																			
Boston	104	....	20	44	36	4	40	....	20	17	3	23	7	2	8	64	27	33	4
New York	158	....	35	55	63	5	61	....	35	20	6	43	9	4	5	97	35	57	5
Philadelphia	75	....	6	20	38	11	19	....	6	9	4	7	6	3	3	56	11	37	8
Cleveland	68	....	5	16	34	13	12	....	5	3	4	5	3	4	....	56	13	30	13
Richmond	129	....	13	57	51	8	21	....	13	7	1	5	9	2	5	108	50	50	8
Atlanta	148	....	10	57	68	13	27	....	10	15	2	11	8	....	8	121	42	67	12
Chicago	221	....	26	60	128	7	64	....	26	35	3	25	16	1	22	157	25	125	7
St. Louis	96	....	5	16	61	14	19	....	5	13	1	6	11	1	1	77	3	60	14
Minneapolis	105	1	5	31	64	4	28	1	5	21	1	6	19	1	2	77	10	63	4
Kansas City	278	....	24	100	140	14	58	....	24	34	....	33	22	....	3	220	66	140	14
Dallas	272	....	33	111	120	8	75	....	33	41	1	27	39	1	8	197	70	119	8
San Francisco	123	4	41	65	11	2	63	4	41	16	2	54	2	....	7	60	49	9	2

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	Amounts (in millions of dollars)																		
All member banks	15,874	72	12,154	2,472	1,148	28	12,869	72	12,154	634	10	12,352	510	7	....	3,004	1,838	1,138	28
Size of bank (total deposits in millions of dollars):																			
Less than 10	554	1	27	175	338	12	82	1	27	52	1	36	45	2	....	472	123	337	12
10–50	857	....	77	402	362	15	207	....	77	128	2	98	107	2	....	649	274	360	15
50–100	499	....	52	270	177	....	149	....	52	93	4	106	41	1	....	350	177	173	(3)
100–500	2,562	....	1,377	912	271	1	1,679	....	1,377	299	2	1,359	317	2	....	883	613	269	1
500 and over	11,403	71	10,620	713	....	....	10,752	71	10,620	62	....	10,752	....	(3)	....	651	651	....	....
Federal Reserve district:																			
Boston	626	....	556	45	25	(3)	577	....	556	18	3	569	8	1	....	49	27	21	(3)
New York	6,060	....	5,793	228	36	3	5,910	....	5,793	116	1	5,878	31	1	....	150	112	35	3
Philadelphia	628	....	467	79	81	1	489	....	467	23	(3)	483	7	(3)	....	139	56	81	1
Cleveland	861	....	712	116	32	1	722	....	712	8	2	712	8	2	....	140	108	30	1
Richmond	401	....	166	163	68	4	173	....	166	7	(3)	86	86	2	....	228	156	68	4
Atlanta	576	....	260	164	142	10	275	....	260	15	....	268	6	(3)	....	301	149	142	10
Chicago	2,260	....	1,621	386	252	1	1,730	....	1,621	106	3	1,614	115	(3)	....	531	280	250	1
St. Louis	424	....	184	36	202	2	211	....	184	27	(3)	189	22	(3)	....	212	9	201	2
Minneapolis	344	71	136	52	85	(3)	241	71	136	34	(3)	213	28	(3)	....	103	18	84	(3)
Kansas City	553	....	219	210	120	3	287	....	219	67	....	193	93	....	....	266	143	120	3
Dallas	1,370	....	554	720	95	1	704	....	554	149	1	600	104	1	....	666	571	94	1
San Francisco	1,770	1	1,485	272	11	(3)	1,551	1	1,485	64	....	1,547	4	....	....	219	208	11	(3)

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a maximum rate in between those shown, it was included in the group paying the next higher rate. In most cases the maximum rate is that applicable to maturities of 1 year or more. When a rate for this maturity was not reported, the rate applicable to the next shorter maturity was used.

[3] Less than $500,000.

NOTE.—Figures may not add to totals because of rounding.

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Table VI

Time Deposits, Open Account, IPC: Maximum Interest Rates Paid by Member Banks, December 3, 1965, and Early 1966

Group	All survey banks with deposits[1]	Maximum rate paid,[2] early 1966 (per cent)					Banks raising rates after Dec. 3, 1965									Banks not raising rates			
							Total	Maximum rate paid,[2] early 1966 (per cent)				Maximum rate paid,[2] Dec. 3, 1965 (per cent)				Total	Maximum rate paid,[2] Dec. 3, 1965 (per cent)		
		5.5	5.0	4.5	4.0	3.5 or less		5.5	5.0	4.5	4.0 or less	4.5	4.0	3.5 or less	No rate		4.5	4.0	3.5 or less
	Number of banks																		
All member banks	1,763	4	91	285	621	762	240	4	91	72	73	91	44	77	28	1,523	213	584	726
Size of bank (total deposits in millions of dollars):																			
Less than 10	810	1	22	93	255	439	92	1	22	22	47	17	10	48	17	718	71	233	414
10–50	624	3	17	77	266	261	61	3	17	24	17	13	18	22	8	563	53	258	252
50–100	128	...	3	41	51	33	17	...	3	7	7	7	2	6	2	111	34	46	31
100–500	144	...	20	53	44	27	36	...	20	14	2	21	13	1	1	108	39	42	27
500 and over	57	...	29	21	5	2	34	...	29	5	...	33	1	...	...	23	16	5	2
F.R. district:																			
Boston	95	...	2	23	37	33	8	...	2	3	3	2	3	3	...	87	20	35	32
New York	300	...	25	45	142	88	60	...	25	15	20	25	9	24	2	240	30	129	81
Philadelphia	292	...	4	18	56	214	41	...	4	7	30	4	6	31	...	251	11	48	192
Cleveland	169	...	4	14	75	76	12	...	4	1	7	4	...	6	2	157	13	70	74
Richmond	187	...	3	26	97	61	11	...	3	8	...	4	6	1	...	176	18	97	61
Atlanta	194	...	5	35	37	117	14	...	5	9	...	3	5	3	3	180	26	37	117
Chicago	233	1	8	28	101	95	22	1	8	8	5	7	4	4	7	211	20	96	95
St. Louis	18	1	...	2	3	12	3	1	...	1	1	...	...	1	2	15	1	3	11
Minneapolis	13	...	...	3	4	6	4	...	...	3	1	...	1	1	2	9	...	4	5
Kansas City	55	...	1	13	17	24	4	...	1	1	2	2	...	1	1	51	12	17	22
Dallas	116	1	9	36	38	32	22	1	9	8	4	5	9	2	6	94	28	34	32
San Francisco	91	1	30	42	14	4	39	1	30	8	...	35	1	...	3	52	34	14	4

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	Amounts (in millions of dollars)																		
All member banks	4,401	10	2,645	1,010	514	222	2,888	10	2,645	219	14	2,804	68	15	......	1,514	791	504	218
Size of banks (total deposits in millions of dollars):																			
Less than 10	155	(3)	4	34	57	58	12	(3)	4	3	4	4	3	5	......	143	31	55	56
10–50	365	9	23	72	174	87	51	9	23	11	8	28	15	7	......	315	61	169	85
50–100	193	......	6	92	83	12	25	......	6	17	2	15	7	2	......	168	75	81	12
100–500	600	......	118	332	92	57	219	......	118	99	1	177	41	1	......	382	233	91	57
500 and over	3,088	......	2,494	479	108	7	2,582	......	2,494	88	......	2,580	2	......	......	508	392	108	7
F.R. district:																			
Boston	58	......	25	15	10	7	26	......	25	(3)	(3)	25	(3)	(3)	......	31	15	10	7
New York	2,102	......	1,682	337	57	25	1,802	......	1,682	116	4	1,786	11	4	......	300	221	54	24
Philadelphia	393	......	201	111	44	37	210	......	201	5	4	201	3	5	......	183	106	43	34
Cleveland	302	......	63	77	149	12	70	......	63	6	2	68	......	2	......	231	71	148	12
Richmond	189	......	23	96	53	16	35	......	23	12	......	23	13	(3)	......	153	84	53	16
Atlanta	128	......	9	58	24	37	13	......	9	4	......	9	3	1	......	115	54	24	37
Chicago	623	(3)	307	104	142	70	347	(3)	307	38	1	338	8	1	......	276	65	141	70
St. Louis	3	......	......	1	1	1	1	......	......	1	......	......	......	1	......	2	(3)	1	1
Minneapolis	2	......	......	(3)	2	(3)	(3)	......	......	(3)	(3)	......	(3)	(3)	......	2	......	2	(3)
Kansas City	36	......	1	19	11	5	2	......	1	1	(3)	2	......	(3)	......	34	18	11	5
Dallas	187	9	56	98	17	7	91	9	56	23	3	64	27	(3)	......	96	76	13	7
San Francisco	379	(3)	276	94	4	5	290	(3)	276	14	......	289	2	......	......	89	80	4	5

[1] Excludes banks that reported no interest rate paid on December 3, 1965, or early 1966. Deposits are as of December 22, 1965.

[2] When a bank reported a maximum rate in between those shown, it was included in the group paying the next higher rate. In most cases the maximum rate is that applicable to maturities of 1 year or more. When a rate for this maturity was not reported, the rate applicable to the next shorter maturity was used.

[3] Less than $500,000.

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Mr. OTTINGER. My time has expired. I would like each of the members of the Board to comment on this; namely, whether if they were given discretionary power to act with respect to the smaller CD's, they would use it or not.

Mr. MITCHELL. I think they are better tools. I agree with Governor Robertson, the maturity tool is the better one than size. I think size would be highly discriminatory, not only to the small saver, but also to the small bank.[1]

The CHAIRMAN. Each member can file their comments. That is your desire, is it not?

Mr. OTTINGER. Yes.

The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. Governor Robertson, last week Mr. Fowler said the balance of payments was further deteriorating and in my view the deficit will be $2.5 billion. Last week before the committee Secretary Fowler insisted that the voluntary restraint program was still only temporary and not semipermanent as I have maintained. Last month Mr. Fowler said the voluntary restraint program would continue for the duration of the Vietnam war. I have been very critical of the program and I am pleased to note I have been joined recently by some of the more responsible elements of our business community. I dispute the contention that the increased deficits are directly or indirectly related primarily to the war in Vietnam. It is my contention that the real trouble lies in the sharply decreased balance of trade surplus and that only a small portion of this decreased surplus can be attributed to Vietnam.

Yesterday the Commerce Department announced figures for it and they, too, were very disturbed. They showed a figure—they showed a further decrease in balance of trade primarily due to the increased imports. Since you have been primarily responsible for this program, would you care to give us your opinion as to when they might be relaxed so we can begin to focus on the real problem how an increase in imports and decrease in exports?

Mr. ROBERTSON. No. 1, I cannot give you any answer as to when this temporary program—and I think it is a temporary program—can be brought to an end. This depends entirely on what happens with respect to the balance-of-payments deficit, and the reaction of European holders of dollars—whether they want to turn them into gold or whether they do not. I would say from all the conversations I have had and from my part in the program, there is a definite understanding that this is a temporary program and not a long-term program.

Also, I think one must recognize that Vietnam cannot be disassociated from the problem. But certainly, a real problem from my point of view is the outflow of funds through investments abroad. The problem is attributable largely to the decrease in our surplus in the trade balance. This is a natural consequence of prosperity in this country, which diminishes exports because there is such a demand in this country for products that it is much easier to sell here than it is to sell abroad and in turn it is perhaps more profitable.

Secondly, in a period such as this when demands are so high, imports increase and this diminishes the trade balance, so that our trade

[1] See also responses of Board members to subsequent questions, particularly pp. 510–511, and Mr. Martin's testimony of June 16, 1966, beginning on p. 531.

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surplus is less and less adequate to take care of the dollar outflows through other avenues.

I think that this problem is one which can be whipped, but not quickly. I have advocated standby authority to impose a tax on international credits and investments, which I think would do the trick. I am not in favor of selective controls of this nature any more than anyone else on this committee or anywhere else, but the problem is so serious and has been so serious that something has had to be done about it and I see no way to cope with it.

Mr. WIDNALL. Of course, as far as our exports are concerned, we would seek some credit from the sale—we have received some from the sale of airplanes which were actually a few items, each one a costly item. At the same time, with imports, we have virtually millions of items coming in that amount up to figures that compare with the export of a few airplanes. I am starting to worry about the fact that in the steel industry the imports have mounted so much that they are now over a 10-percent figure. I can recall not long ago when we first started importing steel where everybody said it would be negligible and we did not have to recognize this as competition and this could go right on without anybody thinking about it or worrying about it—that it cannot affect our own business. It is clear that good steel is being manufactured in many places of the world and this can have a very serious impact on our trade balance and also affect our balance of payments. We are going to have to face up to that one of these days.

Mr. ROBERTSON. I think this is true and as you must recognize also, businessmen in this country have not devoted the same imagination, ingenuity, and drive to the export program that businessmen abroad do in their situations. We must do everything we can to build up export business. We have to see that it is adequately financed, but we also have to see that markets are taken advantage of and we do everything we can to find the markets abroad.

Mr. WIDNALL. Does the voluntary restraint program impose a restraining influence?

Mr. ROBERTSON. I think not. The very fact that the banking industry has a leeway of $800 million unused under the guidelines, indicates there is ample financing for any exports that anyone would wish to make. I have never been able to run down any single situation where an export has been lost for lack of financing.

Mr. WIDNALL. Mr. Brimmer, you were doing some work in this area for the Commerce Department, I believe?

Mr. BRIMMER. I was.

Mr. WIDNALL. I would like to have your comments and your own opinion as to when you feel voluntary restraints might be relaxed so we can focus on the program of increasing imports and decreasing exports.

Mr. BRIMMER. I do not know that the voluntary program could, or should, be relaxed. The general comments and the reason for the program I will not repeat. But I do have an opinion of my own as to why the business community part of the program which I had a responsibility for in the Commerce Department ought to continue for some time into the future.

First, the business community obviously has been the principal source of positive contribution to the balance of payments. You know that. The trade surplus has been adding to the balance of pay-

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ments close to $5 billion a year, and even the temporary decline in the trade surplus described in the news story which you quoted should not be taken as an indication that this trade surplus will disappear or even fall below $4 billion a year. It is one of the largest surpluses among leading nations in relation to the total volume of trade. But the core of the industrial company program involves voluntary restraint or modification of the outflow of funds for direct investment ahead. I think this part of the program might very well have to be continued in some form into the foreseeable future. I do not disassociate the Vietnam program from this.

In my opinion, if the Vietnam program—the Vietnam activity—had not contributed to the deficit something in the order of some $700 million a year, which is a rough estimate at this time, it would have been possible to ease the program during 1966. As it turned out, this is not possible. You will note that I said "ease" the program rather than abandon the program completely. I think the backlog of investment projects, especially in Western Europe, would probably lead to a level of plant and equipment expenditures abroad much higher than could be sustained without stimulating an outflow from the United States well over $3 billion a year. Now, it is a matter of judgment as to whether direct investment outflow of that magnitude should or should not be encouraged. My own feeling is that in 1964, when it was about $2.4 billion, it was at a high level. I think in the absence of some kind of modification, the level would probably be at least $3.5 billion, if not higher. I think the form of the program can and should be modified as we go along. And I should say that the companies themselves have made tremendous strides to modify the outflow. They have borrowed a substantial amount of money in 1965 to modify—to moderate—the outflow. I do not expect that they will continue to make increments in that borrowing year by year on that order of magnitude.

Now, I would foresee that the targets could be relaxed. In other words, rather than making quantitative suggestions, they could be encouraged to follow certain kinds of guidelines which would not put a ceiling on the outflow, but would involve a different composition of outflow. In my judgment, many companies would prefer that kind of arrangement to mandatory controls. We should be reluctant to talk about the possibility of mandatory controls, but I would think that the alternative to such controls is voluntary cooperation. I repeat, I think it would be preferable to have such moderate restraint on a voluntary basis, for some time into the future. I would be reluctant to suggest a target date, because I think the problem is still with us and it is not likely to disappear in the near future.

Mr. WIDNALL. Thank you. Just one further question.

I would appreciate it if you would comment on my guess of $2.5 billion deficit in the balance of payments.

Mr. BRIMMER. I would not wish to comment on it, because I am reluctant to forecast. While working with the Commerce Department program I found we had great difficulty in trying to see ahead 6 months. The deficit has been running about at an annual rate in the first quarter of $2.3 billion, or something of that order of magnitude. There were certain peculiar developments during that quarter because several sizable transactions were simply pushed over from 1965.

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For example, a substantial amount of foreign securities, especially Canadian issues, were postponed from 1965 into 1966. I would not expect that to continue throughout the year. I would expect the rate to be less than $2.5 billion—but I would not want to suggest a particular figure.

Mr. WIDNALL. What more favorable factors do you see that would change this below $2.5 billion?

Mr. BRIMMER. The first thing, as I said earlier, I would expect some further improvement in trade. The pattern of exports which we discussed for the last month or so will probably not persist. I also think there will be some substantial savings on direct investment outflow, especially when you take account of the funds borrowed abroad by U.S. companies. I would expect some improvement in 1966 compared with 1965.

The tourist gap may not in fact widen as much as people have been suggesting. After all, last year it was not as much as we had forecast, so I think we will see some moderation in it. But I would not want to catalog all of the possible favorable things because I have not been working so closely with the balance of payments in the last few months as I was in the Commerce Department. I am not up to date on the details of the latest thinking of the technicians who are working on them.

Mr. WIDNALL. Thank you. My time is up.

(The following information was submitted for the record:)

FEDERAL RESERVE BANK OF NEW YORK,
New York, N.Y., May 25, 1966.

Hon. WILLIAM B. WIDNALL,
Committee on Banking and Currency,
U.S. House of Representatives, Washington, D.C.

DEAR MR. WIDNALL: At the hearings of the Committee on Banking and Currency this morning, you referred to the trade balance of the United States and to various other aspects of our balance-of-payments problem, and you solicited the views of the Federal Reserve representatives on these matters. I was about to make a brief comment when your "time was up" and it was the turn of another committee member to ask questions. I want to say in this letter what I would have said at the hearing, if the clock had not intervened.

Your comments on our exports and our imports highlighted, I think, the important role that stability of prices in the United States plays with respect to our balance of payments.

We have been seeing rapidly expanding business activity, increased demand for and use of credit, declining unemployment, shortages of skilled labor and increased production bottlenecks; in such a setting pressures on prices have been mounting. With an already high utilization of resources, a high aggregate demand for goods and services is pressing on a limited supply.

If we have further increases in prices at home, it will be harder for American products to compete in foreign markets. At the same time, with high demand for goods at home, further increases in prices in the United States will stimulate Americans to buy more imported goods.

Thus it seems to me that general policies designed to slow down the growth of overall demand for goods and services at this time serve the dual purpose of promoting price stability at home and equilibrium in our international payments. Monetary policy is now operating to slow the growth of overall demand. More fiscal restraint (in the form of increased taxes and reduced expenditures) would contribute directly to the same end; it would thereby lessen the need to place too great an anti-inflationary burden on monetary policy, and would reduce the inevitable pressure on interest rates.

Sincerely yours,

WILLIAM F. TREIBER,
First Vice President.

The CHAIRMAN. Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

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Mr. Robertson, on December 6 of 1965 the Federal Reserve Board raised the maximum interest rates payable on time deposits to 5½ percent. Is there any upper limit beyond which the Federal Reserve Board has no authority to go?

Mr. ROBERTSON. None whatsoever.

Mr. GETTYS. Will the gentleman yield?

Mr. McGRATH. I yield.

Mr. GETTYS. Does the State law sometime control that, Mr. Robertson? You cannot authorize national banks to violate a State law, can you?

Mr. ROBERTSON. No. A national bank must comply with ceilings established by State law. State laws may vary in this in some respects.

Mr. McGRATH. That is all I have, Mr. Chairman.

The CHAIRMAN. Mr. Annunzio?

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Yesterday reminded me of primary day with the members selecting whether or not they were for an independent Federal Reserve Board. Some of the members indicated they were for independency of the Board and others indicated they were not for independency of the Board. I want to state my own position.

In a democracy which is a government for, of, and by the people, we cannot afford the luxury of independence. In reviewing the pages of history, we find that those countries which have enjoyed the luxury of independence have reverted to dictatorships, and consequently, more harm than good has come out of a system of complete independence. So I am not in favor of an independent Federal Reserve Board. I do believe it should have some independence, but not total independence from the Congress of the United States and the elected representatives of the people.

I also believe strongly in the two-party system because that is the only way we can have responsibility. At least, you can hold one of the major parties responsible for action. People go to the polls to vote; it is very elementary, but it works.

I was gratified to learn also, Governor Robertson of your position in which you indicated that the action of the Federal Reserve Board in December was responsible for the problem before us and you also made a statement that we must act quickly. I want to ask you, sir, How long is "quickly"?

Mr. ROBERTSON. Again, let me say that this depends entirely on the problem as it emerges, but we cannot afford to sit by and watch the problem get into panic proportions before we act. If you want hours or days, I cannot tell you this. This depends entirely on the Board. But I would fully expect that the problem which is foremost before this committee today is not one that will get out of hand by virtue of lack of action on our part.

Mr. ANNUNZIO. Mr. Brimmer, you are the new man on the Board and I have a question.

Mr. ROBERTSON. Could I just make one statement concerning your comments concerning the independence of the Board?

I think I can say every member of this Board will agree with you. Every member of this Board will agree with you that the Federal Reserve is not independent of Congress. We consider ourselves to be an agent of Congress and we will willingly and wholeheartedly carry out any policy which the Congress prescribes.

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Mr. ANNUNZIO. But you did not do that in December when Mr. Martin met with the President of the United States. The Board went ahead anyway and increased the discount rate.

Mr. ROBERTSON. You have never seen a law enacted by the Congress that we have failed to carry out.

Mr. ANNUNZIO. I have been a member of this committee for 15 months and have heard the chairman refer to the Board as the fourth branch of Government. I refer to it as the fourth estate. I have before me the testimony of Norman Strunk and he says here:

> This relatively new development in the growth of savings certificates obviously was not anticipated when the certificates of deposit first developed a few years ago and it obviously was not anticipated last December when the Federal Reserve permitted the commercial banks to pay as high as 5½ percent on CD's.

Now, Mr. Brimmer, I want to know from you, as a member of the Board, why the Board did not anticipate the increase in certificates of deposit. Members of the Board are not naive people. They are dealing with human beings when they deal with bankers, and when you open the door a little bit for human beings they are going to open the door a little more. I would like your comments.

Mr. BRIMMER. Mr. Congressman, first of all, I appreciate your interest in my opinion on a matter before the Board before I joined it. I am reluctant to go back and second guess my associates as to what was on their minds at the time they took the action last December.

I would prefer to look ahead and if you will permit me, I think it will be helpful to examine somewhat more closely the question of certificates of deposit and what happens when the Board took the action last December. I assume you in fact—I assume Mr. Strunk was talking primarily about negotiable certificates of deposit.

I would like to say that the question of negotiable certificates of deposit we talked about yesterday, we looked at in fact what is happening. In the recent period of—I respectfully suggest you ask the other members what was on their minds. I would like to intonate the growth in certificates of deposit in 1966, the period when growth was concentrated, which roughly is up to March. If you look at that and use the data available, and this is some 350 weekly reporting member banks. As a matter of fact, the growth in certificates of deposit during this roughly 10-week period in 1966 has been roughly the same as it was in 1965. During the same period, the weekly reporting member banks have lost $1.8 billion from their savings accounts and this was in contrast to a growth of almost $600 million such accounts during the same period in 1965.

We also have some breakdown by Federal Reserve districts in the way this has taken place. During the same period, these banks gained $3.4 billion in time deposits other than CD's during the 10 weeks 1966.

Now, it appears that the banks have been gaining in those kinds of time deposits other than negotiable CD's. There you got a rate much more rapid than a year ago. These gains, in my opinion, are due to the kind of special devices designed for consumer-type savings, savings bonds, savings certificates and so on.

I have an opinion on this, but I would not want to go into it in any length. I would say I would be surprised if the Board had not anticipated that some shift in these flows would have taken place. Again, their reasoning I think, what was on their minds at that time——

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Mr. WIDNALL. Will the gentleman yield?

Mr. ANNUNZIO. Yes.

Mr. WIDNALL. I was very interested in your preliminary statement when you started your time. I would like to know what country or countries you feel have made greater progress than we have made with a different system than we have in the Federal Reserve?

Mr. ANNUNZIO. I was not comparing the progress the countries were making from a banking point of view. No one questions the progress that we have made from a social, economic, and political point of view. But I still feel that these agencies, whether they exist in State, city, county or national governments, should be responsible to the people and to the elected officials of the people.

The CHAIRMAN. Will the gentleman yield?

May I add that the so-called independence of the Federal Reserve is of recent innovation. There was no independent Federal Reserve up until 1953. In 1951 there was a declaration of independence in a way, but it was never exercised until 1953, and Mr. Eisenhower was the first President to ever mark them as an agency independent of the executive branch, and, of course, we are all familiar with what has happened after they seized that independence. We had three recessions within 8 years. Industry has paid $60 billion excess interest rates. I think the record will show that the so-called independence has really been seized. It is not granted by the Government. No law grants them independence. They just seized it. Mr. Eisenhower recognized it and since that time they have asserted it even under Democratic administrations.

Has your time expired?

Mr. ANNUNZIO. Yes.

The CHAIRMAN. We have just a little time here. Mr. Fino and Mr. Rees and Mr. Stanton, I think are the only members who have not asked questions. Suppose we finish with them, if we can. If there is no objection, we will stay so they can finish.

Mr. Fino?

Mr. FINO. Thank you, Mr. Chairman.

The CHAIRMAN. You take your full 5 minutes.

Mr. FINO. Mr. Robertson, there are three types of financial institutions offering passbook savings accounts to customers: namely, the savings and loan associations, the commercial banks, and mutual savings banks.

The question is this: What is the amount of passbook savings for each of these types of institutions?

Mr. ROBERTSON. May I give you round figures, because I do not have them. I do not carry those in my mind, but just guessing, around $350 billion for the commercial banks, $140 billion for the savings and loans—somewhere a little less than $50 billion for the mutual savings.

Mr. MAISEL. Not passbook.

Mr. FINO. Passbook savings.

Mr. ROBERTSON. $90 for the commercial banks, $52 for the mutual savings and $110 for the savings and loan, a total of $443.

Mr. MAISEL. Probably a lot of the $110 billion in the savings and loans may be in savings certificates. We do not have the breakdown for that.

Mr. FINO. How have the figures you have given me compare with the figures of a year ago for each of the types of institutions?

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Mr. ROBERTSON. I do not have that in front of me, but I would be glad to send it to the committee.

Mr. FINO. I'd appreciate that.

(The information requested follows:)

Passbook savings accounts in commercial banks, mutual savings banks, and savings and loan associations

	Commerical bank passbook savings accounts		Mutual savings bank deposits [1]		Savings and loan share capital [1]	
	Amount (billions of dollars)	Percent change from previous year	Amount (billions of dollars)	Percent change from previous year	Amount (billions of dollars)	Percent change from previous year
End of year:						
1961	63.9	(2)	38.0	5.3	70.9	14.1
1962	71.0	11.1	41.0	8.0	80.2	13.2
1963	76.3	7.5	44.3	7.9	91.3	13.8
1964	82.9	8.7	48.5	9.6	101.9	11.6
1965	[3] 92.5	11.6	52.1	7.4	110.3	8.2

[1] May include certificates but breakdown unavailable.
[2] Not available.
[3] Estimated on basis of all insured commercial banks.

Mr. FINO. Is there any essential difference between a passbook savings account offered by each of these types of institutions?

Mr. ROBERTSON. I think not. No essential difference.

Mr. FINO. Is there any good reason for differentials in rates on passbook savings accounts on these three types of institutions?

Mr. ROBERTSON. I think not.

Mr. FINO. If we are to impose the same ceiling rate on nonnegotiable CD's for commercial banks and savings and loan associations, why should not the same ceiling rate apply to passbook savings accounts of these three institutions?

Mr. ROBERTSON. I believe all these financial institutions should be operating under the same rules so that I would not argue this point at all.

As to differences, I think they all ought to be subject to ceilings or they should all be free of ceilings.

Mr. FINO. Just justify if you can, in this connection, I would like to have each member of the panel respond.

Justify if you can the continuance of regulation Q with a ceiling of 4 percent when the rate of 4.15 percent is being paid by the U.S. Government on U.S. savings bonds.

Mr. ROBERTSON. Well, I would want to differentiate in my own mind the rate which the U.S. Government pays in order to finance itself from the rate which private financial institutions are either willing or are permitted to pay. I would like to confine my remarks to the desirability or nondesirability of ceilings on payments that can be made. I happen to believe that fundamentally, if we were starting from scratch, you should have no ceilings at all and rates ought to be determined by competitive forces, but I also believe that once you have ceilings you should never raise them abruptly and thus change the competitive pattern abruptly.

I think you ought to do it when there are no pressures whatsoever. If this had been done in 1961 or 1963 when I endeavored to get it done,

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we would not have the sort of situation we have now, because the competitive pattern would have grown up little by little with no pressures. But to remove the ceilings or put them up when there are pressures, changes your pattern completely.

Your savings and loans have a portfolio of assets on which the rate of interest was fixed when the pattern was much lower and they cannot do anything about that. On the other hand, when they make real estate loans at high rates, when the economy is operating close to capacity, the situation is not quite the same because those will be refinanced later whenever the borrower can get a new loan at a lower rate. Once having ceilings in one area, then you should be very circumspect in changing those ceilings abruptly. You ought to do it very gradually only in accordance with the absolute needs of the time and work toward a period when you are in the situation when there are no pressures whatsoever and then remove them.

Mr. FINO. Do all the members of the Board agree with Mr. Robertson in that connection?

Mr. MITCHELL. I am not——

Mr. MAISEL. I think you have made a very important point, that if Congress should impose ceilings they should request us to raise the ceilings on passbooks of commercial banks up to the 5 percent being paid by savings and loan associations. I think the point is a very valid point. The reason why we have the very different rates, 5 percent for savings and loans and 4 percent for commercial banks, is partly historical. Once the current situation calms down, I agree with you, that the question of whether this large differential makes any sense or not should be reexamined.

Mr. GETTYS. You will have a different crowd screaming, though, would you not?

Mr. MITCHELL. I would say there is a rate differential between commercial banks and savings and loan associations, as far as passbook accounts are concerned, at which funds will not move.

The banks can live with a rate of half of 1 percent under the S. & L. rate without losing their funds to that competition. When the differential gets larger than that, funds start to move one way or the other, there is no question about that. So I think there is a differential in the ceilings that would neutralize flows between these associations and the banks.

Mr. SHEPARDSON. I would respond to Mr. Fino, that if we are going to have ceilings, I think they should be the same. I agree with what Governor Mitchell just said as to the competitive situation in the market; the banks might be able to get funds at a little less rate because of other factors than S. & L.'s. If we are going to set mandatory ceilings, I think they should be the same and these various types of institutions should be allowed to compete on whatever basis the total market forces justify.

Mr. FINO. Mr. Brimmer?

Mr. BRIMMER. The only additional comment I may add related to the narrow question which you posed initially. That is the comparison of the passbook rate paid by the commercial banks and the rates available on U.S. savings bonds. I would think that the choice of the rate is obviously up to the Treasury. But I could see a justification for a slightly higher rate and my response is—it is just a little bit

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more liquid than a passbook account and a little more troublesome to get and maintain. I think this smaller degree of liquidity could justify a higher rate.

Mr. FINO. Just one other question. Is it logical to assume that maintenance of the 4-percent rate on commercial bank passbook savings accounts invites the transfer of funds from these accounts to bank CD's?

Mr. ROBERTSON. Very much so. And this is taking place, the sophisticated depositor who is in search of a high rate of interest will go to a savings bond or certificate. Why should he leave his funds in? So the man who is penalized is the one who is unsophisticated, the very one who needs protection.

Mr. FINO. Thank you.

The CHAIRMAN. Mr. Rees?

Mr. REES. Thank you, Mr. Chairman. I would like to have placed in the record an article in the Wall Street Journal of today entitled, "Block to Building—Big Outflow of Savings From S. & L.'s Forces Cut in Mortgage Loans."

The CHAIRMAN. Without objection, it is so ordered.

(The article referred to follows:)

[From the Wall Street Journal, May 25, 1966]

BLOCK TO BUILDING—BIG OUTFLOW OF SAVINGS FROM S&L'S FORCES CUT IN MORTGAGE LOANS—SOME HALT LENDING FOR NOW; BANKS' 5½ PERCENT RATE ON TIME DEPOSITS ATTRACTS FUNDS—DISAPPOINTED HOMEBUYERS

(By Donald Moffit, Staff Reporter of the Wall Street Journal)

Scratch Ned Smokler's new apartment house. The Detroit builder thought he had a mortgage loan lined up last month, but it suddenly fell through.

Scratch several hundred home sales in Los Angeles, too. The buyers were told last month that they qualified for mortgages—but then the two savings and loan associations that were processing their applications suddenly stopped making any mortgage loans at all.

These are no isolated incidents. Mortgage money in the last few weeks has been drying up drastically even for builders and would-be homebuyers who would easily qualify for loans in anything approaching a normal market—indeed, even for some who already had qualified.

A SAVINGS HEMORRHAGE

The reason: Savings and loan associations, which finance more than 40 percent of the Nation's home and apartment mortgages, are seeing savings flow out of their institutions much faster than new savings come in. So they are reducing mortgage lending drastically, and in some extreme cases stopping it altogether for the time being.

As recently as the end of March the situation was far different. A tight-money pinch throughout the economy caused mortgage-interest rates to rise rapidly in the first quarter and prompted mortgage lenders to tighten credit standards. But this squeeze mainly hit "marginal" borrowers—those whose monthly income, in the judgment of lenders, could not quite cover the higher mortgage payments necessitated by the rising interest rates. Loans still were available to those with high credit ratings. Savings deposits in S&L's exceeded withdrawals by $1.3 billion in the first quarter, and the S&L's managed to increase their mortgage lending slightly, to an estimated $5 billion in the first quarter from $4.9 billion in the 1965 period.

In April, though, savings withdrawals from the Nation's S&L's exceeded new deposits by an estimated $500 million to $700 million. That was the biggest 1-month net outflow ever. While a net outflow is not unusual in April because of withdrawals for Federal income tax payments, the outflow in April 1965 amounted to only $99 million.

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In May, with no more pressure on depositors to withdraw funds to settle income tax bills, S&L's usually gain savings. But industry sources say the savings outflow has continued this month. So it is now estimated that, unless funds starts flowing in again heavily, S&L's will cut their mortgage lending in the last 9 months of 1966 to $13 billion, from $19 billion in the 1965 period. A cutback on that scale could crimp residential building severely in the rest of 1966.

HIGHER WITHHOLDING, HIGHER PRICES

What happened? Industry sources generally sketch this picture: Increased withholding from payrolls, for social security taxes at the beginning of the year and now for Federal income taxes as well, has reduced the take-home pay of many consumers—at the same time that rising prices have left the consumers in need of more spendable funds. The new financial pressures appear to have caused many people to stop making new savings deposits and to have forced some to dig into past savings. Some studies indicate much of the money recently withdrawn from S&L's has gone to finance major purchases that consumers apparently no longer can make out of income.

Compounding the trouble for S&L's, commercial banks now appear to be attracting a bigger share of what new savings deposits still are being made, because they now are paying higher rates than the S&L's. This is quite a turnabout. California S&L's not long ago were paying the highest rates on savings (up to 4.85 percent) in the country, advertising these rates widely in the East, and pulling in so much money that worried Federal regulators were putting some downward pressure on these western rates.

Last December, however, the Federal Reserve Board increased the rate that banks are allowed to pay on time deposits (those left in the bank for a specified time, such as 1 year) to 5½ percent from 4½ percent. S&L's officials at first thought this would not hurt them. But as more banks have moved up to the high rates (some now pay 5½ percent on as little as $25) and as savings have flowed out of the S&L's, the industry has changed its mind in a hurry.

WASHINGTON MOVES

Prodded by a pilgrimage of S&L executives to Washington, the industry-regulating Federal Home Loan Bank Board last week moved to lift the unofficial "ceiling" that limits the rates S&L's can pay on deposits. After July 1, S&L's in California and Nevada, which have been particularly pinched, can pay 5 percent on regular deposits, and many have announced they will. Further, Treasury Secretary Fowler late last week proposed to Congress that bank regulators be empowered to lower the interest banks can pay on time deposits of $10,000 or less.

While an increase in the rates they can pay on savings might help S&L's stop further outflows of savings, some industry officials doubt it will enable the S&L's to pull back in the money they already have lost. "It's like throwing a drowning man half a life preserver," says one S&L president.

So, for the time being at least, S&L's can do little but curtail mortgage lending far more drastically than they had expected to a few weeks ago.

In Detroit, despite bank competition, S&L's gained $23 million in new savings during the first quarter of 1966, and were hopeful of maintaining mortgage lending at the $108 million rate of last year. Instead, net savings withdrawals reached $21 million in April and "this year we're cutting back lending to $30 million or $35 million," or less than one-third the 1965 volume, says H. Gehrke, president of Detroit's big First Federal Savings & Loan Association.

Atlanta S&L's are planning to cut their mortgage lending "between 50 percent and 75 percent" in May, June, and July from the $70 million they loaned in those months last year, according to Ed Hiles, executive vice president of Georgia Savings & Loan Association.

In Elmhurst, a Chicago suburb, Elmhurst Federal Savings & Loan Association announced 3 weeks ago it would no longer accept loan applications. "Our savings inflow isn't satisfactory and hasn't been since the first of the year," says Theodore Wilson, president. "We're flatly turning down any and all applications. We think we will just coast for as long as 60 days to see if this market won't shake out."

In southern California, where most of the country's larger S&L's are based, several associations, including those controlled by Lytton Financial Corp., have

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announced they are declining temporarily to accept new mortgage-loan applications.

The Lytton associations say they are fulfilling existing loan commitments. But, says Bart Lytton, chairman of Lytton Financial in Los Angeles, "we're not open to amendments, suggestions, or counter-proposals" from borrowers. "We refer all amendments, suggestions and counter-proposals to those employes we have discharged," he says jokingly. Not so jokingly, Lytton associations have dismissed 170 employes, about one-quarter of their work force, during the past 6 months to keep costs in line with the drop in business.

A few associations, to hear builders and loan agents tell it, even have canceled commitments they already had made to finance the sale of homes. A Los Angeles loan agent contends that 1 S&L ordered escrow agencies to return downpayments and trust deeds (as mortgages are called in California) on 400 homes, the sales of which were awaiting transfer of loan funds from the S&L to sellers. Two weeks before that, the agent says, another association backed out of 200 commitments.

The associations he names deny they ever have canceled a loan commitment. But they concede they stopped processing loan applications in April, including some applications for loans to complete sales on which downpayments already had been put in escrow. On some of these, applicants already had been sent letters indicating tentative approval pending formal action by the S&L loan committees.

A Los Angeles builder says he lost three home sales a few weeks ago because the S&L that had made an oral agreement to finance the purchases broke its word. "They asked me if I had anything in writing. I said no, and they told me to go ahead and sue 'em then," he says.

Savings and loan executives insist such cases are so rare as to be insignificant and say that suspension of new lending by some S&L's is only temporary. A spokesman for the U.S. Savings & Loan League says that "this step has been taken in order to fulfill mortgage commitments previously made" and that S&L's refusing to make new commitments "will return to the market as soon as these existing commitments have been met."

But even the optimists don't foresee a return to the mortgage lending volume of last year. "The lending capacity of the business will fall far short of the demands of American homebuyers," says Norman R. Strunk, executive vice president of the U.S. Savings & Loan League. He thinks S&L mortgage lending for all 1966 may fall to about $18 billion, down nearly 25 percent from $23.9 billion last year.

The consequences for the building industry could be severe. Housing starts, while they have remained about level in annual rate for the last several months, fell below the previous year in both 1964 and 1965, to constitute one of the few soft spots in the economy. Now the cutback in S&L mortgage lending raises a new threat, and economists see little chance that other mortgage lenders such as insurance companies, commercial banks, and mutual savings banks, will step in to fill even part of the gap. These institutions do not concentrate on mortgage loans to the extent S&L's do. Moreover, heavy loan demands from nonconstruction businesses have put a strain on the funds they have available to lend.

As recently as December, the National Association of Home Builders concluded from a survey of its members that housing starts in 1966 would exceed the 1,542,000 of 1965. By March, however, the NAHB decided there would be a "slight decline," perhaps 1 percent. Now, says Norman Farquhar, an economist for the association, "it's like riding a roller coaster. We know we're going down fast, but we don't know where bottom is."

Individual builders, especially in California, long a giant construction market, are just as gloomy. Ben Deane, a Los Angeles area builder, originally planned to put up 1,500 new houses this year. But now he says: "We'll probably go under 1,000 because of the anticipated unavailability of mortgage credit."

"The great majority of homebuilders in Southern California are dependent on the S&L industry, and practically none of them (the S&L's) are making commitments to finance new homes," says builder Larry Weinberg. "A lot of the smaller builders who don't have commitments now are going to be out of business in very short order."

For the S&L's themselves, the situation probably spells a drastic slowdown, at least for 1966, in their super-fast growth rates of recent years. The U.S. League says total savings in S&L's have increased as much as 13 percent a year in recent years, with some S&L's posting gains of 15 percent or even 20 percent.

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The outlook for this year, most industry sources agree, is for much more modest growth at best.

Earnings of the large S&L holding companies either are showing only small gains from a year earlier, or are down sharply. Lytton Financial reported first-quarter profit of $381,590, or 15 cents a share, far below the $1,023,622, or 40 cents a share, earned in the 1965 period. Bart Lytton says cuts in expenses and higher interest rates on mortgage loans may reverse the picture for the rest of the year. But he adds: "Nobody can project earnings now with any degree of certainty."

Investors have rather clearly soured on S&L stocks, too. The Kidder, Peabody & Co. index of S&L stock prices has dropped to 79.40 currently, down from 119 at the end of 1965 and a peak of 397 in November 1961.

Mr. ROBERTSON. We have read it.

Mr. REES. I can see you did not write it.

I would like to explore two areas that I feel are the crux here.

First, the relationship between savings institutions and banks in terms of coordination of decisions being made by both your Board and the Federal Home Loan Bank Board; and second, what is a CD and what is the effect of a CD in competition with other financial institutions and internally within a financial institution? In this context, I would like to discuss the legislation I introduced this week. I am a Congressman from California, from Los Angeles, and we have, of course, a great deal of competition in that area for money, both in the banks and savings and loans, because we are a fast-growing economy. I am reading from an analysis of a billion-dollar savings and loan association, a Federal institution. They are well below the California average in terms of scheduled items. The management I consider to be among the top in the entire industry.

Looking at the types of savings that they have in their institution, 79 percent of their deposits are deposits of $5,000 and more; 53.7 percent are deposits of $9,000 and more. So you can see the pattern here, an investor pattern rather than a savings pattern where mom and dad put a few hundred dollars away for furniture or for future needs. I think you will find this pattern at least throughout the savings and loan industry in the State of California. It is the investor, not a savings pattern.

I would also like to give you the experience of this——

Mr. ROBERTSON. May I ask, are these all CD's you are talking about, or just regular passbook?

Mr. REES. They have not gone into this 3-year savings type of certificate.

Mr. ROBERTSON. So these are the accumulated deposits over the years as people accumulate their funds to buy homes.

Mr. REES. It shows it is primarily investor money. The type of person who puts money in the savings and loans is the person who has funds for investment and part of their portfolio is this type of demand money.

Mr. ROBERTSON. This would be more likely to be true if they were a single deposit of that volume. If they are merely the accumulated deposits of individuals who are trying to buy a home, they might not be.

Mr. REES. These are not people accumulating to buy a home. I would say the average investor is probably 55 years old and probably sold a home and has other assets and seeks this as a ready money investment.

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Mr. ROBERTSON. Do you have any percentages to show the deposits over $100,000?

Mr. REES. Of deposits of $25,000 and over, about 2.85. I would say one family could maybe have $30,000 or $40,000 in three or four insured accounts; one for the wife and one for the child and however it might be. It does show you when you draw the line; it is primarily investor money and not saver money.

In terms of the first quarter of this year, in that institution, they lost deposits of $19 million. This is a great deal of money. And of that, $15 million was in those areas of deposit between $10,000 and $11,000, investor-type money, investing up to the $10,000 insured account limit.

We find basically that there is a flow of this type of money directly into the bank CD. In California the Bank of America is giving 5 percent. It is the smaller banks that are going up to 5½ percent. It is the banks who can least digest a CD that are going up to the 5½-percent basis.

Was there any consultation with your Board and the Federal Home Loan Bank Board before the decision was made on December 6?

Mr. ROBERTSON. I think not.

Mr. REES. Do you not think this is dangerous?

Mr. ROBERTSON. I think it would have been better if we had.

Mr. REES. Do you think there may be a possibility in the future of restructuring both your Board and the Federal Home Loan Bank Board to see that there is some coordination among your policies? We find the situation where your decision is directly affecting the savings and loan industry. The decisions of the Federal Home Loan Bank Board do not affect what you are doing nearly as much.

Mr. ROBERTSON. Yes; they do, too.

Mr. REES. Not nearly as directly as your decision.

Mr. ROBERTSON. I do not want to get into the question of degree, but on both sides, of course, any decision which they make in raising their rates, for example, the rates that are permissible, for those that are coming to borrow from the Federal home loan banks obviously affect in particular areas the rates which savings and loans are paying in contrast to those which banks can pay.

Mr. REES. Did you look at the potential effect of the savings and loans before you made that decision?

Mr. ROBERTSON. I am sure every member of the Board had in mind the possible effect of raising these rates. No one—no one could overlook this, it seems to me. You would not look exclusively at savings and loans. You would look at all financial institutions and this would be part of the background information which every member would want to have before he made his decision.

Mr. REES. Do you not think that we have to have some restructuring so as to have some coordination between the two banking systems?

Mr. ROBERTSON. I am firmly in favor of this and I would be delighted to send you a speech I made last week in which I suggest that action should be taken so that we have more uniform rules.

Mr. REES. I wish you would. It is my prediction that when July comes up we are going to have serious problems of liquidity in the savings and loan industry throughout the United States. The with-

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drawals in the first quarter was a minor withdrawal in terms of what is going to happen.

There should be some differential, some parity in interest rates between banks and savings and loan associations. Do you think it is good in terms of competition? For example, banks have many more advantages than a savings and loan.

Mr. ROBERTSON. May I answer that and then Governor Mitchell, who made this suggestion, may cover it, too.

From my point of view, the reason for the differential of one-half of 1 percent has been the break-even point insofar as competition is concerned between the two institutions—the banks can handle the demand deposits and perform other services for individuals and therefore have the advantage in getting funds and therefore they can pay 4 percent when savings and loans are paying 4½ and not lose to the savings and loans. I do not think this necessarily follows for all time, because more and more people are getting interest conscious. Savers are becoming sophisticated and they may very well move even for less than a half of 1 percent.

But I would prefer to have Governor Mitchell answer that.

The CHAIRMAN. If you will pardon me. You have an amendment, Mr. Rees, I believe. Why do you not explain what your amendment is so that the members will have it in the record, and so the members of the Federal Reserve Board will know about it, too?

Mr. REES. Yes, Mr. Chairman, I wanted to go into that, but it looks like we are being called.

The CHAIRMAN. You will have 3 or 4 minutes.

Mr. REES. Let me explain the bill that was put in last week.

The bill is an attempt to define a certificate of deposit. In the bill we define a certificate of deposit as being a nonnegotiable instrument which must be held for at least 1 year at an interest rate no greater than the passbook rate of the bank.

I have here an analysis by Governor Robertson of the bill. I introduced this bill because I felt that the certificate of deposit is potentially a very destructive instrument. In the newer growing banks in California we have the problem of too many certificates of deposit. You even had it in New York banks where major CD's all became due at a certain time, you had a serious liquidity problem. My bill is an attempt to try to equalize the rates so the small passbook holder would not be at a disadvantage. with the large corporate investor.

The CHAIRMAN. Would you like to place that in the record?

Mr. REES. The bill?

The CHAIRMAN. Your summary and any material that you have concerning your bill. I assume you will offer that amendment.

Mr. REES. Yes.

The CHAIRMAN. You may place it in the record at this point.

Mr. REES. Thank you, Mr. Chairman.

(The analysis on H.R. 15173 by Governor Robertson was previously inserted and may be found on p. 209.)

The CHAIRMAN. All right, we will recess then until tomorrow morning, Governor. We regret very much to ask you to come back. But under the circumstances, we have no alternative.

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Mr. TREIBER. I have been away from the Federal Reserve bank in New York since Monday afternoon and I have some things I think I should take care of.

The CHAIRMAN. Since we have the members here, I think it will be all right to excuse you, Mr. Treiber.

Mr. TREIBER. Certainly.

The CHAIRMAN. All right, we will stand in recess until tomorrow at 10 o'clock.

(Whereupon, at 11:15 a.m., the committee adjourned to reconvene at 10 a.m., Thursday, May 26, 1966. This meeting was subsequently canceled, to reconvene subject to the call of the Chair.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

TUESDAY, MAY 31, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, Moorhead, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Widnall, Mrs. Dwyer, Harvey, Stanton, and Mize.

The Chairman. The committee will please come to order.

This morning the committee continues hearings on H.R. 14026, concerning negotiable certificates of deposit.

Our witnesses are Comptroller of the Currency James J. Saxon, supervisor of the issuance of the Nation's circulating currency as well as of national banks, and Mr. Larry Blackmon, Chicago, Ill., who is president of the National Association of Home Builders. Mr. Blackmon's industry is vitally interested in the CD question because their ability to provide homes for Americans is directly related to the question, "Where is all the money going—Main Street, or Wall Street?"

According to the latest statistics, the modest increases in the money supply created by the Federal Reserve, as well as savings money are turning up in the hands of the customers of the large money-market banks. Of the $18 billion in outstanding negotiable CD's, over 70 percent were issued by just 30 banks, every one with over $1 billion in assets. Over 40 percent of the total—$7 billion—was issued by just a handful of New York City banks. So it is perfectly clear what is causing the pressure on smaller banks, thrift institutions, and homebuilding and home buying.

Mr. Saxon can tell us in detail how the money market national banks he supervises have issued CD's, debentures, notes, and loans to raise cash to finance expansion for their big corporate clients, while Mr. Blackmon, who follows Mr. Saxon as our witness, can tell us the effects of these distorted money flows on other segments of our economy.

Mr. Saxon, we are delighted to have you, sir. You may proceed in your own way. If you will, summarize your statement. I assume you have a copy for each member and it has been placed in front of each member. I have mine and I am sure the other members have one. We would appreciate that very much. Then we would like to ask you questions, sir.

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STATEMENT OF HON. JAMES J. SAXON, COMPTROLLER OF THE CURRENCY

Mr. SAXON. All right, Mr. Chairman.

The CHAIRMAN. Come around, Mr. Blackmon, to the witness place if you will, please. You know Mr. Saxon. Just sit there at the microphone if you will and you will be heard after him. We have asked him to summarize his statement, and we will ask you to do the same thing.

All right, Mr. Saxon.

Mr. SAXON. Mr. Chairman, in response to your suggestion, I will summarize briefly this short statement which deals primarily with regulation Q and the effects that regulation in our opinion has had on the general financial industry in this country, all segments of it, and on the commercial banking business. It is our view that regulation Q has been and is a price-fixing mechanism which is odious to the general principles on which this economy is operated, that this regulation has been destructive of the normal flow of funds to the needs of the market as those needs should be demonstrated by competition among various segments of industry and commerce within our economy, that for many years regulation Q was kept at rates at such low level as to deter the normal flow of funds into commercial banks, and to increase artificially the flow of funds into the savings and loan industry and into the mutual savings banks.

I point out that for many years there was no price regulation on rates or maturities or quantity of funds which S. & L.'s or mutuals could seek in the markets, and even today the only restraint on rates is that which is incidental to the limited control exercised through advances from the home loan banks to the S. & L.'s, whereas today by contrast the commercial banking business is subject to across-the-board rate regulation.

As has been pointed out, this has imperiled the proper function of the economy, has materially affected in a serious adverse way the normal allocation of funds and their most efficient uses in the economy and has benefited artificially and improperly other competing industries, in itself has resulted in the problem to the extent that a problem exists in the savings and loan business which because of Q has had freedom without limit to compete for funds countrywide, without regard to rates, maturities, or other controls.

We note here today that whereas the Federal Reserve continues its restraints on the commercial banking business, the Home Loan Bank Board has just recently announced liberalization of its regulations in terms of liquidity requirements and other requirements, and at a time when, in my opinion, instead of liberalizing the Home Loan Bank it ought to be restraining these institutions. In fact it is not apparently merely a matter of maintaining the status quo in the savings and loan industry today.

It appears to be a matter of providing funds for continued expansion on the presumed basis that these funds are necessary to support the housing industry, much of this of course being directed in these comments primarily to small housing, although we know that large construction is one of the major interests of the housing industry, and that this pressure to continue the existing rate of expansion and

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indeed to increase the expansion is contrary to the requirements of the economy as it exists today with the inflationary pressures that are inherent and apparent in it in some segments, and regulation Q itself is responsible basically, as it has been over the years, and as this problem is now aggravated by the astonishing liberalizing regulations of the Home Loan Bank Board at a time when there ought to be reasonable restraint.

We would also point to the practices engaged in with the approval of the Home Loan Bank Board for excessive appraisals of loans and excessive loan rates, particularly in a period such as we now have here in this country.

We do not believe either that one segment of the industry and business of this country, the housing industry alone, should be protected as a privileged sanctuary, and despite the restraints being imposed on other segments of the economy, the business economy, the principle somehow seems to be developed that the housing industry as a single exception ought to be protected at any cost. This seems to be contrary to the principles which should govern the sound effective functioning of the economy in the period in which we are now living.

We believe that there ought to be some restraints exercised on the lending practices of the S. & L.'s, that there is a serious question whether there ought to be any further expansion at this time, a serious question as to whether such expansion should in any case be financed by public funds through the home loan banks, and whether overall this is not seriously harmful to the economy.

As I noted, to the contrary of these principles we see liberalizing practices. Instead of a substantial expansion in required liquidity, which, as I recommended to Mr. Dillon three and a half years ago, ought to be a minimum of 15 percent of funds exclusive of home loan bank borrowings and exclusive of loan commitments on the books, we have what amounts today as a negative liquidity in the case of S. & L.'s generally.

Now there are some very fine ones that operate according to sound financial principles, but instead of true liquidity we have borrowed liquidity in the main, liquidity based on borrowings from the home loan banks, and it is notable in this respect that this borrowing from and lending by the home loan banks is increasing. It is now at some $6 billion and presumably, if this policy continues, this will expand.

By contrast, restraint in bank lending, it is now clear enough, indicates approximately $600 million total advances by the Fed to the commercial banks. I am not arguing that this restraint in the case of commercial banks should be lifted at all. Perhaps it should be increased, but I do seriously question whether the current policy of the Home Loan Bank Board to liberalize at this critical period, if their own statements can be taken as indicating a critical situation, and I am not sure that this exists nationally at all. I do know in California and a couple of other places there are problems, but I am not persuaded that this is of such monumental significance as to warrant the hysterical—as I would describe it—hysterical reaction I have heard and seen in a number of places.

So a policy of reasonable restraint, a period during which the S. & L.'s, as some of them are now doing thankfully, would not extend their commitments but would attempt to increase their liquidity, their

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true liquidity, their real liquidity, as indeed they could, by using the inflow from present mortgage portfolio amortization to improve their internal situation and to reduce their reliance on the home loan banks in the country.

Instead we see a reduction in liquidity requirements from 7 to 6 percent. This I find impossible to understand.

We therefore, in conclusion, feel that there are two basic problems here. One, the role of regulation Q in this economy, and the artificial restraints, the odious price fixing which regulation Q represents. In this connection I would refer to what I believe as I recollect was the unanimous opinion of the President's Committee on Financial Institutions that regulation Q ought to be put at a minimum on a standby basis. I believe it ought to be abolished altogether.

I believe if regulation Q had been permitted, had been on a standby or had been abolished during the past years, the artificial protection, the privileged sanctuary enjoyed by the savings and loan industry would not have put them in the posture which it is said they have or exist in today. They would have been used and properly used in the competition in the marketplace, and, presumably, as I noted earlier, would have exercised the proper practices that many of them now do, but unfortunately not all.

In conclusion I would note that in the April period the $900 million of withdrawals from the S. & L. industry, that $500 million of this came out of California alone, and that $500 million was furnished back again by the Home Loan Bank of San Francisco.

This is a question of proper policy. It seems to me governmental policy by the Congress, by the administration, which such support is desirable, particularly when it creates an attitude and a policy of protection regardless of the proprieties and the warrants of the money market.

I would note too that this industry has been well subsidized through the years. The 1964 tax figures of the Treasury showed that contrary to a projected 20- to 22-percent tax rate on all mutuals, mutual savings banks and S. & L.'s, that the 1964 figures showed much less actually paid by S. & L.'s and the mutual savings banks.

In this connection I would like to note that one of the other major competitors for the available funds in the money market at any given point of time is the insurance industry. It is the one industry that initially obtains its funds free of any cost through the premium. Here too this is an industry which pays lesser taxes as its earnings grow. It paid something slightly over one-half of the taxes paid by the commercial banking industry in 1964.

I note this item merely to suggest that there is a serious question whether this type of privilege, this type of protection provides for the best development in an efficiently operating financial economy.

That concludes my statement, Mr. Chairman.

(The complete statement of Mr. Saxon follows:)

STATEMENT OF JAMES J. SAXON, COMPTROLLER OF THE CURRENCY

During the past few weeks, this committee has heard testimony on several proposals which are directed towards curbing competition between savings and loan associations and commercial banks. Rather than focus my attention on these proposals, I wish to address my statement to what in my opinion is the fundamental issue which underlies these proposals. Whether we think that the

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difficulty which now plagues the savings and loan industry is a permanent problem, a transitional problem, or no problem at all, the basic issue is still the same: Should regulation Q be used to regulate price competition among financial institutions.

A cardinal principle of our free enterprise system is that government should impose economic regulation only in those areas where free market forces lead to results that are not in the public interest. When the government intervenes to fix prices, administrative decisions are substituted for those of the marketplace—the decisions of one man or a very few men replace the judgments of many. There may be instances in which this is a desirable course, but the burden of proof should rest with those who would advocate more controls over competition, since competition has long been accepted by both scholars and businessmen as the driving force behind our system of free enterprise. Indeed, a competitive system is at the roots of our traditional political and economic philosophies. Although several proponents of more control have recently appeared before this committee, no one to my knowledge has offered the kind of convincing evidence we should demand before acting to increase the restraints on our thriving financial system.

Restriction on interest payments go back to the Banking Act of 1933, conceived in the midst of our worst financial crisis. There was remarkably little discussion of interest payments on deposits when that act was under consideration. What discussion there was rested on the assumption that the banking troubles of the 1930's were the result of imprudent banking practices. Such practices were forced upon the commercial banks, so the argument ran, by the severe competition for correspondent and other deposit balances. This competition, it was argued, led to high interest rates on deposits, which compelled banks to acquire risky assets, thereby exposing themselves to the illiquidity that pervaded the banking crisis of 1933.

There is no evidence, however, to support the view that rate competition for time deposits during the 1920's was excessive and led banks to "reach" for unsound assets. In fact, during this period rates paid on time deposits by member banks actually declined. In addition, from 1920 to 1929 commercial banks successfully maintained their holdings of government bonds at about 10 percent of total earning assets, indicating that they did not attempt to increase their earnings by reducing the proportion of high-quality assets in their portfolios. More recently, after reviewing the evidence, both the Commission on Money and Credit and the President's Committee on Financial Institutions concluded that interest-rate ceilings are generally undesirable.

Current competitive relationships between commercial banks and savings and loan associations should be examined in the perspective of the whole post-World War II period. From 1946 to 1962, commercial banks operated at a serious disadvantage in competing for savings because of the relatively low regulation Q ceilings. For example, until 1962 banks were limited to a maximum rate payable of 3 percent on time and savings deposits, while many savings and loan associations paid 4 percent or higher at times. In the 1946–61 period, commercial bank time and savings deposits increased by $44.9 billion, while savings at savings and loan associations increased by $63.5 billion. This was nearly a ninefold increase for savings and loan associations, compared to less-than-a-twofold increase for commercial banks. During the last 4 years, on the other hand, with the commercial banks operating under less restrictive rate ceilings, the growth in commercial banks time and savings deposits and in savings at savings and loan associations was nearly equal.

To my knowledge, the competitive relationship of the last 4 years have not had any harmful or destructive effects on financial institutions. As far as commercial banks are concerned, their position is sound, whether we look at quality of assets, earnings, or their liquidity position. Bank earnings are at an alltime high. The quality of bank assets has been improving in recent months. An aspect of tight money conditions and strong loan demand is that it allows banks to improve their portfolios by weeding out their marginal loans. Bank liquidity positions are also sound. This is something we follow very closely and an analysis of our most recent examination reports shows that the 200 largest banks have, on average, liquid assets equal to about 30 percent of deposits. These banks have unquestionably been the most aggressive competitors for time deposit funds.

Although I do not have detailed knowledge of the savings and loan industry, there is, in my opinion, no reason to believe that the industry is facing widespread insolvencies. If there were any basis for the fears that have been ex-

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pressed about the industry, the Home Loan Bank Board would be tightening up rather than liberalizing requirements for reserves and liquidity of member associations. However, recent actions of the Board, according to its own press release, have "liberalized dividend rates, reserve requirements, and liquidity requirements of savings and loan associations." It is difficult for me to understand why the present situation calls for additional restrictions on commercial banks when the Home Loan Bank Board is moving in the opposite direction and liberalizing requirements on savings and loan associations.

I recognize, of course, that compared to past years, the savings and loan industry has been experiencing slower growth in recent months. Although savings and loan associations would like to return to the "good old days" during which banks were not allowed to compete vigorously, it is unreasonable to expect a return to the distorted competitive relationships of the 1950's. Rather than returning to the 1950's savings and loan associations must face up to prospects of slower growth in the future, together with its corollary of lower profits and reduced tax benefits. (To some extent, as long as savings and loans grow rapidly they pay virtually no taxes. In 1964, for example, savings and loan associations paid Federal taxes of only $124 million, or 17 percent of income after dividends.)

It is clear that the kind of competition for savings funds we have witnessed in recent years has not led to "dangerous" or "destructive" competition but rather has brought about a healthy and vigorous financial system. Moreover, not only are there no dangers in removing regulation Q, but there are real advantages to be gained.

The interest-rate rigidities imposed by regulation Q distort the allocation of resources between different types of financial institutions as well as among commercial banks themselves. Because of greater efficiency, some banks could pay more than the existing ceiling rate without engaging in imprudent banking practices. Other banks, which are less efficient, find the ceiling a convenient shelter from the rigors of competition. Regulation Q, therefore, imposes price controls that protect the inefficient and discourage the efficient, a result which conflicts with the goals of our free enterprise system.

Even if this inefficiency were the sole cost of regulation Q, and it most definitely is not, I would regard it as sufficient justification for abolishing these rate ceilings.

Another aspect that should be noted is the publicity associated with changes in regulation Q ceilings. This publicity, and indeed the publicity associated with these hearings, calls public attention to the 5½ percent rate allowable under regulation Q. As a result, many people feel that the Government has specified 5½ percent as the rate that banks should pay and that they are being cheated if their bank pays less. It is not just the financially unsophisticated who make this mistake. The recent Home Loan Bank Board actions were reported in the Atlanta Journal as follows:

"The Federal Home Loan Bank Board told savings and loan associations they must pay as high as 5 percent interest on some forms of savings accounts."

This kind of misinterpretation seems inevitable if we continue to have fixed ceilings on interest rates which are subject to infrequent and highly publicized changes.

In closing, I have been unable to discover any dangers which are clearly associated with rate competition for savings funds, and am convinced that by eliminating regulation Q our financial structure, indeed the entire economy, would realize significant benefits. The proposals now before this committee would remedy the dislocations and distortions stemming from regulation Q by saddling our financial system with even more controls and greater rigidity. I do not think that these proposals are in the interest of either the financial community or the public.

The CHAIRMAN. Thank you, sir.

Now, Mr. Blackmon, please take about 10 minutes and hit the high points of your statement and then the entire statement will be placed in the record immediately after your oral statement as Mr. Saxon's will be placed after his. The committee then would like to ask the two of you questions and bring out all the important points. If indeed certain points are not brought out at the end of our interrogation, you will be perfectly free to bring them out, and if not brought out by yourselves, you can extend your remarks in the record.

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STATEMENT OF LARRY BLACKMON, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. BLACKMON. Thank you, Mr. Chairman and members of the committee. I was before the Subcommittee on Housing a couple of months ago and testified on certain aspects of the housing bill, most of which we supported. There were a few items we did not support. However, in my opening remarks, I said that NAHB supported the bill but we were concerned about present monetary policy and the effect it was going to have on our industry and as being a major factor in what we could and would do this year and in years to come.

Mr. Saxon stated that special treatment was being given to the savings and loan institutions, and that the housing industry had received special treatment. I would say this to you gentlemen: many years ago it was determined by this body that special treatment should be given to encourage the American Nation to be a nation of homeownership.

The CHAIRMAN. Mr. Blackmon, of course we shall be glad to hear you any time on that, but really our question is now on the CD's.

Mr. BLACKMON. Yes, sir.

The CHAIRMAN. I have an idea that your time would be used in accordance with my suggestion. This will be appreciated by the committee on that particular question. This other thing will not be overlooked. You may put anything in the record which you wish to.

Mr. BLACKMON. I was concerned, Mr. Chairman, that there was an attack on the savings institutions because the CD's themselves—I was getting to that——

The CHAIRMAN. That is all right. Then you use your time as you desire.

Mr. BLACKMON. Congress determined that homeownership is a great thing in this country and that it would strengthen America. Therefore it established the policy of encouraging savings in institutions concentrating on residential lending. Over many years small savers have been given a higher rate of interest than others. It is only in recent years that an administrative change in policy permitted CD's to pay a larger amount than savings in savings and loans and savings banks of this country. I think this change is responsible for the present chaotic condition in the Nation's monetary policy. When the Federal Reserve Board issued regulations relaxing regulation Q to permit CD's to bear interest at 5½ percent without any guidelines whatsoever, it resulted in small savings being shifted from savings institutions into commercial banks. The commercial banks are using these funds not for investment in long-term loans as they were in the savings institutions; they are being invested in items of short-term duration such as automobiles and other consumer financing. This just aggravates the overheating of the economy rather than slowing it down.

One of the reasons given for the relaxation of regulation Q last fall was that banks were unable to cope with their funding of the large volume of CD's coming due at that time. I do not see how they can hope to cope with the situation now if they could not cope with it last November and December. Banks have been encouraged to enlarge this problem rather than to bring it under control.

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To get back to the basic statement I was making earlier. Shifting large amounts of money from one industry to another or from savings institutions to commercial banks results in chaotic conditions in the economy. The problem could be solved by overhauling our system and creating a super board made up of the Comptroller of the Currency, the Secretary of the Treasury, the Federal Reserve, the Council of Economic Advisers, the Secretary of HUD, and the Home Loan Bank Board. This Board should have formal meetings in which it takes into consideration the overall welfare of the Nation and in which direction we should go, rather than having one segment, such as the Federal Reserve, issuing a regulation that has a great impact on other segments of our monetary policy and of our industry.

I think that this is necessary and I would like to urge this body to create such a board. Our monetary policy in this country would be coordinated more effectively as a result.

I believe, Mr. Chairman, that is all the comment I would make at this time and I will be available for questions. I would at the end of this like to make one comment concerning Fannie Mae that might be of interest to the whole committee, but which does not concern CD's.

(The complete statement of Mr. Blackmon follows:)

STATEMENT OF LARRY BLACKMON, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and members of the committee, approximately 2 months ago I appeared before the Subcommittee on Housing on the Demonstration Cities Act and related bills. At that time, I said that the homebuilding industry's support for those bills was tempered by the fact that monetary pressures on our industry were rapidly crippling our capacity to produce the kind and volume of homes American families require.

Since then, necessary long-term credit which is the lifeblood of our industry has become less and less available to our customers. Consequently, all over our Nation the American homebuilding industry—one of the Nation's most important industries—is in serious distress.

Without a vigorous homebuilding industry the American economy cannot long remain healthy. The economic importance of homebuilding is briefly described in attachment A. This huge, basic industry is today in danger of serious credit starvation from which it will not quickly recover, if continued much longer.

One major cause of this critical slump is the loss by savings and loan institutions and savings banks of savings deposits pulled into the commercial banking system by last fall's amendment of regulation Q. A previous witness gave you the figures on the extent of this drain on savings and loan deposits and the resultant drastic impairment of the lending capacity of the savings and loan system. To finance its customers, homebuilding depends on savings and loans (and savings banks which are suffering equally).

We therefore believe the hearings you are conducting on this subject are most timely. It is the considered opinion of the American homebuilding industry that the deliberate diversion of savings from long-term investment into short-term, high-yield commercial lending has grave implications for the continued vitality of the homebuilding industry, and, therefore, inevitably for the entire American economy.

By raising the maximum permissible interest rate on time deposits to 5½ percent from 4½ percent and in reducing to 30 days their minimum permissible term, the Federal Reserve Board set in motion the forces which have produced this result. At the time it was intimated that this interest rate rise was designed to permit banks to work out of the awkward situation in which they found themselves as a result of increasing use of certificates of deposit. The action has not by any means reduced the size of that problem. On the contrary, it has sharply increased the amount of certificates outstanding. Bank funds held under certificates rose from $16.3 billion in November 1965 to $17.4 billion on April 20, 1966. If at the end of the last year the banking system could not handle the lower amount of maturing certificates at the then maximum of 4½

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percent, how will it be able, in the months to come, to refinance the larger (and growing) amount at a sharply higher interest rate? And, particularly, how can banks cope with this growing load of debt when the minimum maturity of certificates has been shortened to as little as 30 days?

If the general level of interest rates does not decline prior to the maturity of large volumes of these certificates, the Federal Reserve Board may decide it is necessary to raise the permissible rate even higher than 5½ percent, regardless of the serious reaction this may have on other segments of the economy.

We fear—and I use that word advisedly—that the concept of certificates of deposit as a substitute for long-term savings will become permanently imbedded in the commercial banking system. Originally used sparingly as an attraction for temporary corporate surpluses, certificates of deposit are rapidly being exploited as a device to seek long-term savings of the small saver—in short, to compete with savings institutions. It is this fierce and unfair competition which deprives homebuyers of credit to buy new, or to refinance existing, homes. I say "unfair" competition, because in an interest-rate war long-term investors simply cannot compete; they cannot raise their earnings as rapidly or as flexibly as can commercial banks whose funds turn over rapidly in short-term investments. Two recent news items from the Wall Street Journal will serve to illustrate what is happening. They are attached as exhibits I and II.

If allowed to compete for these savings practically without restraint, commercial banks can take most of it for their own uses—which are not the uses which support homebuilding and other industries based on long-term credit.

In brief, we believe the current situation gives rise to two extremely serious problems, the first a problem for the commercial banking system in coping with the large and increasing volume of certificates of deposit issued at higher interest rates and, the second, the governmental problem as to how far commercial banks should be permitted to go in competing with savings institutions for long-term savings.

We are shocked at recent newspaper reports of a proposal advanced by no less an official than Vice Chairman of the Federal Reserve Board, which would in effect convert savings institutions into commercial banks. We find in it no indication where residential mortgage loans of the future are to come from. Apparently this is a matter of small concern to those who set credit policies. It is high time that the importance of residential credit be recognized.

We have for some time urged that the monetary system has become too complex to be left to the unilateral action of one agency and that an overall policy board should be established to include representatives of the Home Loan Bank Board, Comptroller of the Currency, Secretary of the Treasury, Secretary of Housing and Urban Development, Council of Economic Advisers, and the Federal Reserve Board.

The entire situation is aggravated by the present "tight money" crisis. In this connection, I enclose for the committee's information an interim policy statement (exhibit III) issued by the board of directors of our association at its meeting in Washington last month. As set forth therein, we strongly believe monetary policy should not solely be relied upon to restrain the overall economy. It simply will not work. The major consequence of such a policy is to restrict homebuilding, small businesses, and local government without restraining spending by big corporations and consumer spending, both of which elements are major contributors to the current inflationary danger.

If we are to avoid disastrous consequences to our country's economy, the restraints need to be shared equally and soon. It is already almost too late so far as much of the spring and summer building seasons are concerned.

Mutual savings banks net inflow for the first quarter of 1966 was 36 percent less than a year ago, and savings and loan associations were down 31 percent. These are the funds necessary to maintain a reasonable level of homebuilding. Without them the situation assumes crisis proportions. Because of the long leadtime in the homebuilding business, the sharp decline which will occur later this year has not yet been recorded; most homes now starting construction are financed by mortgage commitments issued last fall.

Unless the conditions on which we have very briefly touched are quickly corrected—unless restraints are imposed on the use of certificates of deposit to recognize that the savings pool must be preserved for long-term capital investment and not used up in short-term, higher yield commercial lending—irreparable damage to the homebuilding industry, to other business, and to the Nation could result.

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[Attachment A]

SIGNIFICANCE OF HOMEBUILDING IN THE AMERICAN ECONOMY

The impact of new residential construction is a major force in, and spreads throughout the entire American economic structure. For example, last year's 1½ million new dwelling units generated in construction activity alone approximately $21 billion. When you add to this the impact of expenditures which are directly related to the construction of new dwellings, such as schools, community facilities, service industries, durable goods expenditures, and the like, the total directly related impact of housing expenditures amounts to $35 billion, or approximately $1 in every $18 of the total amount of gross national product activity last year.

Each new home built provides about 2 man-years of employment, half offsite, a little more than half onsite. Last year's housing volume thus provided close to 3 million jobs. In addition, what the economists call the multiplier effect of such expenditures is also enormous. For example, it has been calculated that the multiplier effect of construction activity as it spreads through the economy in economic terms is about double the direct dollar expenditures. The thousands of products used in new dwellings come from every area of the country and affect virtually every industry. What follows is an analysis of this impact in more detailed form.

SINGLE-FAMILY UNITS

Construction cost (structure alone).—One million single-family homes represent a total direct construction expenditure of about $16 billion, or approximately $16,000 per house.[1] In terms of labor this means 3,300 man-hours of employment per home, or approximately 2 million man-years of employment in the single-family housing sector alone.[2]

SITE IMPROVEMENT

In addition to home construction the site improvement costs are estimated to be $2,200 per home, or a contribution of $2.2 billion to the gross national product.[3]

MULTIFAMILY UNITS

Construction cost.—The construction cost in 1964 of the multifamily structures alone represents at least an additional $5 billion contribution to the gross national product.

The amount spent on site improvements of multifamily units approached $1 billion in 1964.

COMMUNITY DEVELOPMENT

The building of new homes stimulates other types of construction activity. They mean new or bigger schools, more churches, better highways, community facilities, expansion of public utilities, etc. A conservative estimate of these related construction activities would be $3,000 per single family and $1,000 per multifamly unit, or an additional $4 billion added to the gross national product.[4]

ADDITIONAL DIRECT EXPENDITURES

Upon completion of a home and its purchase, an additional $1,000 per unit is generated by the service industries. This would include the commission the builder would pay to the real estate broker, the settlement costs the purchaser would pay the title company, a loan placement fee which would be paid to the local lending institution, fee paid to an appraiser, land surveyor, and real estate transfer taxes paid to both the local and Federal Governments.[5]

DURABLE GOODS AND FURNISHINGS

A new unit, whether single family or an apartment, necessitates the purchase of new appliances, rugs, drapes and curtains, garden plants and equipment,

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[1] Based on Bureau of the Census C–25 series, "Sales Housing," February 1965.

[2] Bureau of Labor Statistics. "Labor and Material Requirements for Private One-Family House Construction," June 1964.

[3] Housing and Home Finance Agency, 16th Annual Report, table III–35, p. 100. Modified to new sales price of new homes as published by the Bureau of the Census, C–25 series.

[4] M. L. Colean, R. J. Saulnier, "Economic Impact of the Construction of 100,000 Houses." Chicago: The United States Savings & Loan League.

[5] NAHB economics department estimate.

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furniture, and for some, maybe even a new car. New homeowners also spend about $200 the first year on improvements. The total expenditure is estimated to be approximately $3,000 per unit, or $3 billion additional goods and services in our economy.[6]

RELATED SERVICE EXPENDITURES

During the first year the average homeowner will spend an additional $2,000: Real estate taxes on the average new house being built are approximately $400 a year. Interest on an $18,000 mortgage would be an additional $1,020. Insurance for fire, liability, theft, etc., would be between $60 and $100 a year.[7] Heat and utilities an additional $360, maintenance and repair $150.[8]

THE MULTIPLIER EFFECT

Measuring the direct expenditures resulting from the construction of 1½ million housing units each year, a total demand for goods and services of approximately $35 billion is generated.

The employment of these goods and services and the wages paid generate additional purchasing power with the resultant stimulation of virtually every sector of the economy. Conservative estimates of this multiplier factor suggest than these billions spent on new construction itself generates at least an equal amount of other economic activity, thus bringing the total economic impact to $70 billion.

HIGH LEVEL OF HOMEBUILDING ESSENTIAL TO THE ECONOMY

New housing construction generates not only demand for on- and off-site construction activity, the services of local banking, insurance, and real estate agencies, but the manufacturer has a large stake in the homebuilding market. Each home provides a market for better than 3,000 different items.[9]

Any change in new construction volume, though it may be slight, would be felt by thousands of factories, national distributors, and their local suppliers. In addition, millions of workers in the industrial community far removed from the construction site would, likewise, be affected.

According to a recent study by the Bureau of Labor Statistics, each $1,000 of single-family home construction price generates a demand for 72 man-hours of employment onsite, 35 man-hours in transportation, trade, and related services, 38 man-hours in the manufacturing stage, and 12 man-hours offsite construction activity. In addition to these "primary" man-hours, they show an additional 47 "secondary" man-hours. Translating this into employment statistics we find that for each $1,000 of construction activity, there are 204 man-hours of employment generated.[10] A slowdown in construction activity, therefore, would have far-reaching effects on the economy of any community and, in fact, the Nation as a whole.

[From the Wall Street Journal, May 25, 1966]

EXHIBIT I

BLOCK TO BUILDING—BIG OUTFLOW OF SAVINGS FROM S&L'S FORCES CUT IN MORTGAGE LOANS—SOME HALT LENDING FOR NOW; BANKS' 5½-PERCENT RATE ON TIME DEPOSITS ATTRACTS FUNDS—DISAPPOINTED HOMEBUYERS

(By Donald Moffitt, Staff Reporter of the Wall Street Journal)

Scratch Ned Smokler's new apartment house. The Detroit builder thought he had a mortgage loan lined up last month, but it suddenly fell through.

Scratch several hundred home sales in Los Angeles, too. The buyers were told last month that they qualified for mortgages—but then the two savings and loan associations that were processing their applications suddenly stopped making any mortgage loans at all.

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[6] Colean, Saulnier, op. cit., and NAHB economics department estimate.
[7] Based on Bureau of the Census, "Sales Housing," C–25 series; Housing and Home Finance Agency; American Bankers Association; U.S. Savings & Loan League.
[8] Survey of Current Business, and Bureau of the Census, C–25 series, "Upkeep and Improvements."
[9] Estimate by NAHB economics department, based on Colean and Saulnier, op. cit.
[10] Bureau of Labor Statistics, "Labor and Material Requirements for Private One-Family House Construction," Bulletin No. 1404, June 1964, p. 5.

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These are no isolated incidents. Mortgage money in the last few weeks has been drying up drastically even for builders and would-be homebuyers who would easily qualify for loans in anything approaching a normal market—indeed, even for some who already had qualified.

A SAVINGS HEMORRHAGE

The reason: Savings and loan associations, which finance more than 40 percent of the Nation's home and apartment mortgages, are seeing savings flow out of their institutions much faster than new savings come in. So they are reducing mortgage lending drastically, and in some extreme cases stopping it altogether for the time being.

As recently as the end of March the situation was far different. A tight-money pinch throughout the economy caused mortgage interest rates to rise rapidly in the first quarter and prompted mortgage lenders to tighten credit standards. But this squeeze mainly hit "marginal" borrowers—those whose monthly income, in the judgment of lenders, could not quite cover the higher mortgage payments necessitated by the rising interest rates. Loans still were available to those with high credit ratings. Savings deposits in S&L's exceeded withdrawals by $1.3 billion in the first quarter, and the S&L's managed to increase their mortgage lending slightly, to an estimated $5 billion in the first quarter from $4.9 billion in the 1965 period.

In April, though, savings withdrawals from the Nation's S&L's exceeded new deposits by an estimated $500 million to $700 million. That was the biggest 1-month net outflow ever. While a net outflow is not unusual in April because of withdrawals for Federal income tax payments, the outflow in April 1965 amounted to only $99 million.

In May, with no more pressure on depositors to withdraw funds to settle income tax bills, S&L's usually gain savings. But industry sources say the savings outflow has continued this month. So it is now estimated that, unless funds start flowing in again heavily, S&L's will cut their mortgage lending in the last 9 months of 1966 to $13 billion, from the $19 billion in the 1965 period. A cutback on that scale could crimp residential building severely in the rest of 1966.

HIGHER WITHHOLDING; HIGHER PRICES

What happened? Industry sources generally sketch this picture: Increased withholding from payrolls, for social security taxes at the beginning of the year and now for Federal income taxes as well, has reduced the take-home pay of many consumers—at the same time that rising prices have left the consumers in need of more spendable funds. The new financial pressures appear to have caused many people to stop making new savings deposits and to have forced some to dig into past savings. Some studies indicate much of the money recently withdrawn from S&L's has gone to finance major purchases that consumers apparently no longer can make out of income.

Compounding the trouble for S&L's, commercial banks now appear to be attracting a bigger share of what new savings deposits still are being made, because they now are paying higher rates than the S&L's. This is quite a turnabout. California S&L's not long ago were paying the highest rates on savings (up to 4.85 percent) in the country, advertising these rates widely in the East, and pulling in so much money that worried Federal regulators were putting some downward pressure on these western rates.

Last December, however, the Federal Reserve Board increased the rate that banks are allowed to pay on time deposits (those left in the bank for a specified time, such as 1 year) to 5½ percent from 4½ percent. S&L officials at first thought this would not hurt them. But as more banks have moved up the high rates (some now pay 5½ percent on as little as $25) and as savings have flowed out of the S&L's, the industry has changed its mind in a hurry.

WASHINGTON MOVES

Prodded by a pilgrimage of S&L executives to Washington, the industry-regulating Federal Home Loan Bank Board last week moved to lift the unofficial "ceiling" that limits the rates S&L's can pay on deposits. After July 1, S&L's in California and Nevada, which have been particularly pinched, can pay 5 percent on regular deposits, and many have announced they will. Further, Treasury Secretary Fowler late last week proposed to Congress that bank

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regulators be empowered to lower the interest banks can pay on time deposits of $10,000 or less.

While an increase in the rates they can pay on savings might help S&L's stop further outflows of savings, some industry officials doubt it will enable the S&L's to pull back in the money they already have lost. "It's like throwing a drowning man half a life preserver," says one S&L president.

So, for the time being at least, S&L's can do little but curtail mortgage lending far more drastically than they had expected to a few weeks ago.

In Detroit, despite bank competition, S&L's gained $23 million in new savings during the first quarter of 1966, and were hopeful of maintaining mortgage lending at the $108 million rate of last year. Instead, net savings withdrawals reached $21 million in April and "this year we're cutting back lending to $30 million or $35 million," or less than one-third the 1965 volume, says H. Gehrke, president of Detroit's big First Federal Savings & Loan Association.

Atlanta S&L's are planning to cut their mortgage lending "between 50 percent and 75 percent" in May, June, and July from the $70 million they loaned in those months last year, according to Ed Hiles, executive vice president of Georgia Savings & Loan Association.

In Elmhurst, a Chicago suburb, Elmhurst Federal Savings & Loan Association announced 3 weeks ago it would no longer accept loan applications. "Our savings inflow isn't satisfactory and hasn't been since the first of the year," says Theodore Wilson, president. "We're flatly turning down any and all applications. We think we will just coast for as long as 60 days to see if this market won't shake out."

In southern California, where most of the country's larger S&L's are based, several associations, including those controlled by Lytton Financial Corp., have announced they are declining temporarily to accept new mortgage loan applications.

The Lytton associations say they are fulfilling existing loan commitments. But, says Bart Lytton, chairman of Lytton Financial in Los Angeles, "we're not open to amendments, suggestions, or counter-proposals" from borrowers. "We refer all amendments, suggestions and counter-proposals to those employes we have discharged," he say jokingly. Not so jokingly, Lytton associations have dismissed 170 employes, about one-quarter of their work force, during the past 6 months to keep costs in line with the drop in business.

A few associations, to hear builders and loan agents tell it, even have canceled commitments they already had made to finance the sale of homes. A Los Angeles loan agent contends that 1 S&L ordered escrow agencies to return downpayments and trust deeds (as mortgages are called in California) on 400 homes, the sales of which were awaiting transfer of loan funds from the S&L to sellers. Two weeks before that, the agent says, another association backed out of 200 commitments.

The associations he names deny they ever have canceled a loan commitment. But they concede they stopped processing loan applications in April, including some applications for loans to complete sales on which downpayments already had been put in escrow. On some of these, applicants already had been sent letters indicating tentative approval pending formal action by the S&L loan committees.

A Los Angeles builder says he lost three home sales a few weeks ago because the S&L that had made an oral agreement to finance the purchases broke its word. "They asked me if I had anything in writing. I said 'No,' and they told me to go ahead and sue 'em then," he says.

Savings and loan executives insist such cases are so rare as to be insignificant and say that suspension of new lending by some S&L's is only temporary. A spokeman for the U.S. Savings & Loan League says that "this step has been taken in order to fulfill mortgage commitments previously made" and that S&L's refusing to make new commitments "will return to the market as soon as these existing commitments have been met."

But even the optimists don't foresee a return to the mortgage lending volume of last year. "The lending capacity of the business will fall far short of the demands of American homebuyers," says Norman R. Strunk, executive vice president of the U.S. Savings & Loan League. He thinks S&L mortgage lending for all 1966 may fall to about $18 billion, down nearly 25 percent from $23.9 billion last year.

The consequences for the building industry could be severe. Housing starts, while they have remained about level in annual rate for the last several months,

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fell below the previous year in both 1964 and 1965, to constitute one of the few soft spots in the economy. Now the cutback in S&L mortgage lending raises a new threat, and economists see little chance that other mortgage lenders such as insurance companies, commercial banks, and mutual savings banks, will step in to fill even part of the gap. These institutions do not concentrate on mortgage loans to the extent S&L's do. Moreover, heavy loan demands from nonconstruction businesses have put a strain on the funds they have available to lend.

As recently as December, the National Association of Home Builders concluded from a survey of its members that housing starts in 1966 would exceed the 1,542,000 of 1965. By March, however, the NAHB decided there would be a "slight decline," perhaps 1 percent. Now, says Norman Farquhar, an economist for the association, "it's like riding a roller coaster. We know we're going down fast, but we don't know where bottom is."

Individual builders, especially in California, long a giant construction market, are just as gloomy. Ben Deane, a Los Angeles area builder, originally planned to put up 1,500 new houses this year. But now he says: "We'll probably go under 1,000 because of the anticipated unavailability of mortgage credit."

"The great majority of homebuilders in southern California are dependent on the S&L industry, and practically none of them (the S&L's) are making commitments to finance new homes," says builder Larry Weinberg. "A lot of the smaller builders who don't have commitments now are going to be out of business in very short order."

For the S&L's themselves, the situation probably spells a drastic slowdown, at least for 1966, in their super-fast growth rates of recent years. The U.S. League says total savings in S&L's have increased as much as 13 percent a year in recent years, with some S&L's posting gains of 15 percent or even 20 percent. The outlook for this year, most industry sources agree, is for much more modest growth at best.

Earnings of the large S&L holding companies either are showing only small gains from a year earlier, or are down sharply. Lytton Financial reported first-quarter profit of $381,590, or 15 cents a share, far below the $1,023,622, or 40 cents a share, earned in the 1965 period. Bart Lytton says cuts in expenses and higher interest rates on mortgage loans may reverse the picture for the rest of the year. But he adds: "Nobody can project earnings now with any degree of certainty."

Investors have rather clearly soured on S&L stocks, too. The Kidder, Peabody & Co. index of S&L stock prices has dropped to 79.40 currently, down from 119 at the end of 1965 and a peak of 397 in November 1961.

[From the Wall Street Journal, Mar. 30, 1966]

EXHIBIT II

SEVERAL NEW YORK CITY SAVINGS UNITS REPORT HEAVY WITHDRAWALS—SAVERS APPARENTLY SEEKING HIGHER INTEREST RATES ON CERTIFICATES AS 3-DAY "GRACE PERIOD" STARTS

(By a Wall Street Journal Staff Reporter)

NEW YORK.—Several leading New York City savings institutions reported heavy withdrawals by savers who were apparently seeking higher interest returns elsewhere.

For many of the city's savings banks and savings and loan concerns yesterday was the first day of a 3-day "grace period" during which depositors may withdraw funds without losing interest payments for the quarter ending tomorrow.

Bowery Savings Bank, the country's largest mutual savings bank, said net withdrawals for the day totaled $7.3 million, up from $3.6 million a year earlier and from $7 million on December 29, the first day of grace in the last quarter of 1965. Bowery said large institutional investors withdrew $1.4 million of the total amount; similar figures for earlier periods weren't immediately available.

Alfred S. Mills, president of the New York Bank for Savings, said incomplete figures for the day indicated that net withdrawals would exceed the $3.5 million total reported a year ago and would just about equal the $5.1 million total of last December 29.

A large savings and loan association in Manhattan, which declined the use of its name, said net withdrawals yesterday totaled $500,000, up sharply from $245,000 on the corresponding day a year earlier and $250,000 on December 29.

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SWITCH TO SAVINGS CERTIFICATES

The heavy switching from savings institutions in the New York City area presumably was mainly to larger commercial banks in Metropolitan New York, many of which are offering savings certificates paying a return of 5 percent and even more in some cases. Most mutual savings banks and savings and loan concerns, by contrast, are paying 4½ percent on regular savings accounts.

Many of the commercial banks, which are barred from paying more than the prevailing 4 percent on passbook savings, also were hit by a switching problem—mainly by withdrawals from regular savings accounts by customers who used the funds to invest in a bank's own savings certificates with a higher yield. But in some instances commercial-bank savers withdraw funds from banks not offering higher yielding certificates to purchase those of other banks.

Among larger New York banks offering 5 percent savings certificates mainly in minimum denominations of $2,500 and for 9 months or more are First National City Bank, Chase Manhattan Bank, and Bankers Trust Co. But some large suburban Long Island banks are offering an even higher return, including Meadow Brook National Bank, with rates as high as 5¼ percent and Franklin National Bank, 5.10 percent.

A savings and loan executive, Michael Zarrilli, president of West Side Federal Savings & Loan Association, said net withdrawals at his concern were "a little heavier than usual." He said customers making withdrawals "tell us the money is going into either certificates or the stock market," and added that clients are about equally divided.

Some thrift institution officials also noted that first-quarter withdrawals are often used to make income tax payments due April 15.

A savings and loan official told of a neighborhood businessman who for 4 years had maintained an account containing at least $40,000. The official said "the businessman came to us today, said he liked us and liked to support neighborhood institutions, but he was still going to withdraw his money and buy certificates at First National City Bank."

Officials of New York City commercial banks said they didn't have any immediate figures on any spurt in savings certificate sales. But one banker commented, "I'm sure we're going to see a substantial increase in new savings certificates placed with depositors."

At the same time that savings and loan associations in the New York area were experiencing heavy withdrawals due to rate differentials, such institutions in New York and elsewhere faced tougher sledding on still another front. Federal home loan banks, which make loans to member savings and loans and savings banks to help them meet withdrawals, have been raising their lending charges in recent weeks in line with increases in interest rates generally.

Another round of interest-rate increases by Federal home loan banks will start affecting savings and loan associations with the next few days, industry sources say.

According to their information, at least 8 of the 12 district banks will be posting higher charges on loans to associations about April 1. While various banks have separately increased charges a number of times lately, the latest moves are generally considered to be the second general round so far this year.

Basically, the increases are prompted by the higher rates encountered by the System on its own money-market borrowings. In mid-March, the System paid a 5.40 percent rate on a $543 million note offer, matching the highest it has ever paid.

SOME OF THE RAISES

The Greensboro, N.C., district bank raised its rate to 5½ percent yesterday. Expected to follow suit shortly are the Spokane and Topeka district banks. The Spokane bank is currently at 4⅞ percent and the Topeka bank 5 percent. The Pittsburgh and Chicago banks are moving up to 5⅜ percent from 5¼ percent and 4¾ percent, respectively.

The Cincinnati bank is going to a 5¼ percent rate from 5 percent, the Indianapolis bank to 5⅛ percent from 4⅞ percent, and the Des Moines bank to 5⅛ percent from 4¾ percent. Some industry men expect the Little Rock bank to move soon to 5⅜ percent from 5 percent, but said they couldn't confirm this.

The Boston, New York, and San Francisco banks are said to be remaining at 5 percent. All the rates apply to whichever kind of loan is the most commonly made by each bank. In most cases, this is a short-term secured loan.

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The New York savings institutions' withdrawals were seen as foreshadowing similar switching expected to occur among financial institutions in other parts of the country after the interest-paying period ends Thursday. Switching commences earlier in New York because of the laws' provision that lets institutions pay interest to the end of the quarter even though funds are withdrawn in the 3-day grace period that began yesterday.

Exhibit III

The Following Statement Is a Synopsis of the Resolutions Adopted by the Board of Directors of the National Association of Home Builders at Its 1966 Spring Meeting With Respect to National Monetary and Fiscal Policies

Our deep concern for our country's welfare and the future of the important homebuilding industry requires that we summarize, in this interim policy statement, the potentially disastrous condition of our industry, arising from improperly balanced national fiscal and monetary policies, and that we suggest the indicated remedies. With each day that passes the situation worsens. Actions taken too late are no better than no action at all.

While virtually all other sectors of the economy are expanding, homebuilding operates under severe restraints. Homebuyers, particularly those of moderate means, are inordinately affected; it will soon be literally impossible to build for families of low or moderate income.

Unless quickly corrected, this could lead to irreparable damage to the industry, to other business, and to the Nation.

Meanwhile, without visible impairment, credit continues to flow freely in recordbreaking amounts, into industrial expansion and into short-term and higher yielding consumer loans. The stated objective of monetary restraint to "cool our overheated economy" is not being accomplished; in fact it is further feeding the fires of inflation.

The homebuilding industry does not believe the burden of restraining inflation should fall so heavily on our industry. We believe that necessary actions to prevent inflation (an objective which we heartily endorse) must, to be effective, more equally restrain all segments of the economy and—perhaps particularly—Federal, State, and local government construction and other spending, which can reasonably be deferred.

Effective coordination between all Government agencies dealing with monetary and fiscal policy is an essential ingredient to a stable economy and to the mortgage market. The monetary and fiscal system of this Nation are too complex to be subject to unilateral action of any one agency. The President should establish immediately an overall policy board (including representatives of Federal Reserve Board, Home Loan Bank Board, Comptroller of the Currency, Secretary of the Treasury, Secretary of Housing and Urban Development, and Council of Economic Advisers) to consider the impact of any monetary or fiscal action on all elements of the economy.

These actions, if taken immediately and pursued vigorously, could avoid repeal of the investment tax credit provision or increased income taxes.

We vigorously oppose mandatory wage and price controls, which prevent operation of a free market. We recognize that such controls may be imposed on the economy unless the recommendations in this statement are immediately and effectively implemented.

To permit Federal National Mortgage Association to continue to fulfill its function of "backstopping" the mortgage market when other secondary lenders are not available, its debenture-issuing power, now limited to 10 times authorized capital and surplus, should be doubled. This will permit FNMA to rescind the recent $15,000 maximum loan limitation and other limitations which have acted to further increase discounts on loans not eligible for FNMA purchase.

Building trades unions' demands for wage increase have flagrantly violated the wage-price guideline proposed by the Council of Economic Advisers as a means to combat inflationary labor costs in the construction industry. There is no excuse for recognition of increases which violate the guideline in governmental determination of "prevailing wages" under the Davis-Bacon Act which affects all publicly financed construction and multifamily housing financed under the National Housing Act. Further, such measures as the common situs picketing

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bill can only strengthen the hands of those seeking further to escalate the steep spiral of construction labor increases of recent months.

We vigorously support appropriate action in conformity with these principles.

The CHAIRMAN. Thank you very much, Mr. Blackmon.

Mr. Saxon, you mentioned getting rid of regulation Q, and of course, that would be unrestrained competition. Would there be any limit, any restraints, in a case like that?

Mr. SAXON. That would depend on the good judgment of the banks themselves.

The CHAIRMAN. I think you are correct, but what about the *Minnesota* case where a number of bankers all went in together and themselves agreed to restrain competition, did a lot of things that were not in the public interest, and then were indicted in a criminal case. It involved over a quarter of a million dollars in fines, I believe.

Mr. SAXON. Mr. Chairman, there are two different questions.

The CHAIRMAN. In other words, that shows that if you leave it up to them entirely, there will be abuses. Now that was, we will say, an exception. But if you have no regulation Q, you have no limit.

Mr. SAXON. It seems to me the question involves two different principles. The one, conspiracy to agree to fix prices, and secondly a question whether there should be rate control and freedom of banks, that is institution by institution, to compete as need arises and warrants for funds. I do not see any conflict in the two. The Government in that case did exercise its statutory authority and responsibility to move in to question the one practice, and succeeded, but I do not think this offends the principle, in my opinion, of freedom of competition for funds at all.

The CHAIRMAN. All right. Now you state that you support free competition among our financial institutions, including, I assume savings and loan associations, credit unions, and mutual savings banks. I wonder if you would be in favor of allowing these other institutions to offer checking account services? That would be maximum competition.

Mr. SAXON. No, I do not think so. These institutions were created as a special type institution with particular emphasis on housing construction. They are engaged in other activities through the open-end mortgage. Many of them do installment loan and single payment to consumer financing and engage in other types of financing, but no, I would not, because this would——

The CHAIRMAN. I do not want to take up too much time. I want the other members to ask questions.

Mr. WIDNALL. Mr. Chairman.

The CHAIRMAN. Yes, sir.

Mr. WIDNALL. Mr. Saxon, if the banks are permitted to have millions of dollars on which they pay no interest, and I am talking about checking accounts now, why should not the savings and loans have the same type of opportunity to accumulate funds?

Mr. SAXON. Banks are engaged in an entirely different character of business, Mr. Widnall, the broad sweep of commercial, mortgage, consumer installment, other types of financing, capital financing across the board. They are deposit institutions, and as such it is a debtor-creditor relationship, and liquidity based on demand deposits

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is essential to provide the means of meeting their liquidity and their needs.

I do not see that the problem here arises from a lack of capacity to engage generally in the commercial banking business. The problem to the extent that it exists—and, as I say, I believe this has been substantially exaggerated so far as I can determine—I am not sitting on the Home Loan Bank Board and do not know the cases one by one, but I wonder, from what I have heard, whether it is not substantially exaggerated—as to whether this industry, the savings and loan industry, which has done a good and useful job in this country, should not be subject, particularly in a period like this, to reasonable restraints in terms of prudent banking practices.

The problems that exist in California today, exist because of highly excessive lending on large projects, housing construction, office building construction, large block development, much of which still overhangs the market from San Diego to San Francisco, and also into Las Vegas and Phoenix, and are not the result of any restraints on institutions which are soundly managed, but because of excesses.

Institutions are 100 to 110 percent loaned up, making 90-percent loans on excessive appraisals. This is the problem.

The CHAIRMAN. I have about 1 minute left, Mr. Saxon, and I want to ask a question not entirely related to this. There is a lot of talk about balance of payments. Do you know of any other country in the world that does not control exports of its capital overseas except the United States?

Mr. SAXON. I know offhand, Mr. Chairman, of no major country that does not have some form, whether it is in terms of exchange restrictions——

The CHAIRMAN. Yes.

Mr. SAXON (continuing). Or restrictions on the transfer of capital or exports.

The CHAIRMAN. That is right.

Mr. SAXON. One form or another.

The CHAIRMAN. That is right, fine.

Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

Mr. Saxon, like other members of the committee, I have been concerned by the enormous growth of negotiable CD's from practically zero 5 years ago to $17.5 billion today. I have been concerned recently not only because of the diversion of part of that total that would otherwise be available to savings and loans for homebuilding mortgages, but also because much of that money, when it gets into the banking system, is used for making loans which have an inflationary potential. I am thinking particularly of inventory loans.

One of the reasons why negotiable CD's are so irresistibly attractive to the large banks which issue them is because of the fact that they, under the Federal Reserve's rules, have a reserve requirement of only 4 percent, as against a reserve requirement on demand deposits of 16½ percent. Yet, from the standpoint of the corporation owning the certificate of deposit, it is very like a demand deposit with the secondary market available. They can divert that into cash very quickly.

Mr. SAXON. Yes.

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Mr. REUSS. My own approach to this problem, which our committee is wrestling with, has been along the following lines: First, I believe that an overall coordinating board, somewhat along the lines as suggested by Mr. Blackmon, would be in the public interest. Second, I think that the Federal Reserve should be empowered to raise reserve requirements on time deposits over the present level of 3 to 6 percent which has statutory authorization, to something perhaps equal to the level on demand deposits, giving the Fed opportunity to make whatever reasonable classifications among the different time deposit instruments it wishes.

My question to you is, would it not be in the public interest for Congress to vest the monetary authorities with that kind of authorization?

Mr. SAXON. Mr. Reuss, supposing the Federal Reserve does not have the authority now, and I do not know offhand whether they do or not——

Mr. REUSS. It does not. The present authority is only between 3 and 6 percent on all savings.

Mr. SAXON. On savings.

Mr. REUSS. And time deposits, too.

Mr. SAXON. On the principle which premises your statement and question, whether or not the two types of deposits should not be equated so far as reserves are concerned or substantially so——

Mr. REUSS. Let me interrupt to say that I did not say they had to be equated.

Mr. SAXON. Have the power.

Mr. REUSS. I propose simply to give the Fed power to raise it to the present level of demand deposits, or anywhere in between.

Mr. SAXON. I would think selected controls of this type are and would be unfortunate, to select out one type of funds for special treatment. It would work harmful results.

The question in my mind would be whether or not the Fed should not eliminate the reserve requirement on time and savings accounts, particularly savings accounts today. I do not know why, what justification there is for retaining reserve on time funds.

Mr. REUSS. Let us put to one side savings, which have a 4-percent ceiling.

Mr. SAXON. Yes.

Mr. REUSS. They have a very modest 4-percent reserve requirement. I am talking about negotiable CD's.

Mr. SAXON. I would think not. The CD is not as new an instrument as much of the current literature would seem to indicate. We have a record of the substantial issuance and outstanding amounts of negotiable CD's going back to the early thirties and before then. One bank in particular, was a very large issuer of CD's in the early thirties, and there were others. This received tremendous publicity and interest at the time City Bank opened it up on a broad scale in New York. But it is not in accord with the facts to say that the CD began 5 years ago or did not exist substantially until 5 years ago. This is not true.

Now of course there has been a very substantial expansion of it, but it also was a substantial factor as much as 20 and 30 years ago.

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The CHAIRMAN. You mean negotiable CD's?

Mr. SAXON. Yes, Mr. Chairman.

Mr. WIDNALL. Will the gentleman yield?

Mr. SAXON. Yes, Mr. Chairman.

Mr. WIDNALL. In what denominations?

Mr. SAXON. The denominations were varied. I cannot give you, Mr. Widnall, a precise figure, but the amount was substantial.

Mr. WIDNALL. I think there is a great deal of difference between denominations of $1 million or $100,000 and denominations of $250 and $500 which you can get today.

Mr. SAXON. Well, there is a difference in amount, but the large——

Mr. WIDNALL. I think it is important. Now they were doing this you say back in the early thirties?

Mr. SAXON. Yes.

Mr. WIDNALL. What were the denominations they were issuing at that time?

Mr. SAXON. I would have to get some figures for you if I can on this, but they were—the denominations were quite substantial.

The CHAIRMAN. You are recognized, Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman.

I would like to continue to follow up on liquidity. The bank has the ability to lend you $100,000 and say, "There is one condition in connection with this. You must retain $25,000 in a checking account in our bank and a minimum balance of $25,000." They do not pay anything for that $25,000, do they?

Mr. SAXON. That is correct, sir.

Mr. WIDNALL. What do they do with the $25,000? Do they lend it out, make money on it?

Mr. SAXON. That is correct, sir.

Mr. WIDNALL. Does the savings and loan have the same ability?

Mr. SAXON. Either that or invest it or use it as liquidity, one or the other as the liquidity, cash liquidity.

Mr. WIDNALL. Do the savings and loans have the same ability to do that? They have to pay interest on any of their money, do they not?

Mr. SAXON. Yes, they pay money, although they have other systems that are substitutes for this. They are very active in the points area. Points on loans now are running from 2 to 7 around the country.

Mr. WIDNALL. Banks do the same thing, do they not?

Mr. SAXON. To the extent that this exists, it is minor, and to a limit of 1 point. We are talking 2 to 7 points. In the case of a $1 million loan that is $20,000 to $70,000.

Mr. WIDNALL. The point I am trying to make is that when you are comparing savings and loans with the banks, where the banks can make substantial sums, it can be done without actually having to borrow the money or pay for it.

Mr. SAXON. Yes. I think this is a traditional practice, and it has been a good one, so as to assure to the maximum extent possible that funds are available to all. This is true particularly in the case of the larger borrowers. This is not normal, as you know, in the case of smaller borrowers. Where the compensating account exists, it is mainly for the substantial borrowers, and I think this is a good and

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proper practice to assure that while these funds are not being used but are on credit, to the extent of the compensating balance such funds shall be available for other borrowers.

Mr. WIDNALL. I just read in the paper today an ad for a bank saying that if you maintain a $500 balance, why there will be no charge against your checking account. Some have a $1,000 balance. I know that there are probably millions of dollars that banks have in checking accounts that do not freely flow because there is a guaranteed balance within them, and these are not counted in the loan area, but they do have the ability to pick up a great many millions of dollars toward their liquidity without borrowing from anybody, and without any charges at all, that have to be paid by the bank.

The savings and loans of course are dependent entirely on their savings, and they have to pay interest on all of those savings, and I would agree with you that they have a problem of borrowed liquidity at the present time. This may be true with some of the other financial institutions. But they do not count the sources of money that are available to the banks, and where the certificates of deposit have hurt, particularly in the lower denominations, has been in withdrawals from the savings and loan institutions. I think they have had to borrow from the Federal Home Loan Bank in order to meet the withdrawals caused by people taking out small amounts of money and placing them in certificates of deposit.

I know of a number of individual instances where this has been taking place.

Mr. SAXON. Yes, I am sure this is true. But I am not sure I see the efficacy of the point. This industry has been seeking to attract funds without rate regulation for years, has not provided internal liquidity except in terms of a minority of the institutions. They are 100 percent loaned out. I think it is a matter of management of the institution on a sound financial basis, and without excessive reliance on the home loan banks.

The commercial banks are under severe restraint in borrowing from the Federal Reserve, not only in times like these, but ordinarily. They are supposedly emergency loans. Generally after 2 to 3 weeks if a bank continues to borrow heavily from the Fed or excessively, depending on the size of the bank, a call is received from the Federal Reserve bank of the region or district questioning them or requiring a cessation of the practice, and indeed we deal with this in our own examination reports, every one of them, where there has been any continued borrowing—(a) continued borrowing and (b) at a level which seems disproportionate.

It seems to me this is a false infusion of funds, or it can be developed into a false reliance on an infusion of governmental funds.

Mr. WIDNALL. With respect to commercial banks, how much of a percentage of reduction has there been within the last year in money going into the mortgage field?

Mr. SAXON. I do not know the figures offhand, Mr. Widnall. I will supply these for the record. Since the Fed liberalized regulation Q, there has been a very substantial increase in commercial bank entry into the mortgage field, as you know. Now what has happened in the last few months I do not know.

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(The information referred to follows:)

Real estate loans, insured commercial banks

Date	Dollar volume (millions of dollars)	Percent of total loans
Dec. 20, 1963	$38,861	25.0
Dec. 31, 1964	43,436	24.9
Dec. 31, 1965	49,026	24.5
Increase during 1964	4,575	
Increase during 1965	5,590	

NOTE.—Because of a change in the definition of real estate loans in the 1965 report of condition, figures for 1963 and 1964 are somewhat overstated relative to 1965.

Mr. WIDNALL. We do know this up in the area that I happen to represent in Congress. There certainly is a shortage of mortgage funds, a very substantial one. Do you have any comment on that, Mr. Blackmon?

Mr. BLACKMON. Yes, sir. I take issue with Mr. Saxon on the fact that the national banks are going into the mortgage business. In fact the truth of the matter is that many of them have been selling off their portfolio of mortgages. There is a tremendous shortage of money for the financing of homes in this country as a result of this CD draining money from the savings and loans, and I might say also the savings banks, because they are in the same category as the savings and loans. But the commercial banks around the country, to my knowledge, have not been increasing their purchasing of home mortgages. I think statistics will show that over the last year they have unloaded a great deal of their portfolio.

Mr. WIDNALL. Thank you. My time is up.

The CHAIRMAN. Yes, sir.

Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

Mr. Saxon, I am delighted to have you with us this morning.

I notice on the first page of your prepared statement that you make strong reference to the effect of competition on our economic system, which you seem to consider to be a very important consideration in promoting efficiency in our financial institutions.

I take it you feel that, neglecting problems of adjustment, the removal of regulation Q and ceilings on rates that savings and loans can pay would promote competition.

Mr. SAXON. Yes, sir.

Mr. TODD. I believe this was recommended by the President's Commission on Money and Credit.

Mr. SAXON. Yes, sir.

Mr. TODD. Am I correct in that statement?

Mr. SAXON. Yes, sir.

Mr. TODD. Do you feel that it would be beneficial for the same reasons to remove the 4-percent ceiling that banks pay now on passbook savings?

Mr. SAXON. I think the answer is yes, that there is a differential disadvantage in the face of the small saver.

Mr. TODD. And that this would thereby promote competition which you feel is of substantial significance.

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Mr. SAXON. I think banks—and this is generally my experience here—the banks have not been excessive in competing for funds generally throughout the country at all. As a whole as we look at the picture, particularly in the CD area in the great mass of the banks, the national banks certainly which we see, are using their competitive power quite moderately. I do not see excesses here. I think the differential does raise a question, the differential between the small saver and the large saver of between 4 to 5 or 5½ percent as a maximum.

Mr. TODD. In other words, you think, if I see your philosophy correctly, you think that the enhancement of competition which would result if the passbook savings rate were raised would not only increase the efficiency of the financial institutions but be in accord with our general philosophy of free competition in our economy.

Mr. SAXON. That is correct.

Mr. TODD. That the regulatory agency really has the function to determine financial soundness of the institution and not to allocate the resources between them.

Mr. SAXON. Yes, sir.

Mr. TODD. The competition——

Mr. SAXON. Yes, sir.

Mr. TODD (continuing). Should be the one that allocates the resources.

Mr. SAXON. Yes, sir.

Mr. TODD. Then would I be correct in believing that you feel the broad public interest is promoted by competition, and that it clearly outweighs our traditional means of regulating the interest rate ceilings, that the promotion of competition——

Mr. SAXON. The answer is yes, the most efficient mechanism of allocating resources to their most effective use in the economy. I do not know how the Government can perform this function as efficiently. We talk about the housing industry. We project *x* starts. Now who can profess to say what the starts should be outside of the normal demand generated throughout the country and reflected in terms of the market forces.

Mr. TODD. So that the role of the regulatory agency then would be one of promoting financial soundness, but at the same time promoting competition between the various agencies which are being regulated, and this would be the primary public interest consideration of the agency.

Mr. SAXON. That competition ought to exist among all of the financial businesses generally.

Mr. TODD. Well then, would you feel that if the regulations were issued by a regulatory agency which had some anticompetitive effect, that this would have to be, if it were to be in the public interest, it would have to be addressed to the financial stability of the institution? In other words, the only reason for issuing a regulation which is anticompetitive would be one which would effect the financial soundness of the institution.

Mr. SAXON. I think this is correct. We attempted to meet this problem and did effectively in connection with the smaller national banks and their acceptance of time funds on negotiable CD issues outside of their normal market area, and we issued an instruction to all examiners that this practice was to be proscribed. We indicated that

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any of these banks out of territory, out of trade area funds, ought to be related to the normal deposit structure of the bank and other tests of this sort. This is what I mean by using the regulatory technique to effect financial soundness and stability.

Mr. TODD. The reason I bring this up—and my time is expiring—is we were to a certain extent on different sides of the bank merger bill, but I think we both, based on this colloquy, believe that competition is the primary function of a regulatory agency and there is a primary public interest involved in financial institutions, would that not be correct?

Mr. SAXON. Yes, sir.

Mr. TODD. Fine. Thank you very much.

The CHAIRMAN. Mr. Ottinger.

Mr. OTTINGER. Thank you, Mr. Chairman.

I am disturbed, Mr. Saxon, by a number of your statements. I do not think they are really an accurate reflection of the way the money market works. We have a highly regulated industry in the banking industry and various credit and thrift institutions all have a relationship to each other, changing the regulation of one necessarily sharply affects what can be done in the other.

It seems to me what actually happened was quite different from what you describe with the liberalizing of regulation Q at the same time that the rediscount rate was put up. The increase of the rediscount rate was a proper attempt to restrict credit overall in the economy to curb the inflationary pressures that we had. However, at the same time the Federal Reserve Board, by increasing the rates payable on CD's, lifted the lid on restraint applied to commercial banks so that the credit flowed from the thrift institutions into the commercial banks and industrial credit became relatively easy. The whole burden of the inflationary curb was placed on this one segment of the economy.

The Home Loan Bank Board has not liberalized its liquidity rules as a matter of policy because it wants to, but it has acted in desperation because it was feeling such a tight pinch on available funds attributable to the siphoning off of its funds to CD's. It is not a question of the home industry being protected while other segments of the financial world are restricted but it has been quite the contrary. Commercial banks have been permitted to expand credit almost without limit through the device of the high-interest-bearing CD, while the lid is on in a great many ways on the homebuilding industry and the savings and loans and thrift institutions.

I think this is one of the things that greatly disturbs many of us on the committee. These interrelationships are not given proper regard by the various regulatory agencies acting quite independently of the other. Does that not disturb you at all?

Mr. SAXON. I would not say that. There should be consultation and coordination and indeed there is. We have a coordinating committee which meets regularly. I think we have had seven meetings. Six of them were taken up primarily with discussion of the S. & L. industry and generally led by Mr. Horne himself. I did not mean to suggest that there is any lack——

Mr. OTTINGER. The Federal Reserve Board said it did not consult the Home Loan Bank Board in making its decisions.

Mr. SAXON. No; and it did not consult our office, either, as a matter of fact. I received the first word of the announcement of the change

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in regulation Q from the Monday morning newspapers, to be frank with you. I believe in coordination. We have this Committee and we have been working along with them, with the Secretary of the Treasury being involved whenever he can. But on the other hand my question goes to Q itself and I do not think the S. & L. problem that exists today would have existed if Q had not imposed the restraints it has on banks.

The two types of institutions would have learned to live with competition in the market years ago, and we would not face what resulted from the changes that came in 1962 from Q. I do not think the Home Loan Bank Board has moved to meet these changes. Many of the institutions have, though. They have begun to restrain themselves, and you certainly, I am sure, read the statement of the head of the Home Loan Bank of Greensboro, N.C., in which he stated that the industry ought to retrench now for the time being and lay the basis for future growth in order to increase its liquidity.

Banks today are—most of them at least—using this period of tighter money to improve their own portfolio where that is necessary.

Mr. OTTINGER. Do you not see any danger in bank liquidity from these CD's without any reserves behind them?

Mr. SAXON. Well, there are different types, Mr. Ottinger. In the case of many of the banks, CD's are protected by the primary liquidity in the form of cash resources. Secondly, secondary reserves and in the reliance on prime quality of short-term paper in the banks' portfolios. But I would like to read the figures just taken recently of the 200 largest banks of the country. I think it would be of great interest to the committee in view of some of the statements that I read in the press. Now here are the figures.

Loan deposit ratios of the 200 largest national banks of the country, 62.5 percent. Now in a period like this, this figure is certainly not excessive. Net liquid assets to total deposits, 27 percent. Net liquid assets to total deposits, 30 percent.

Now these figures hardly indicate an illiquid position in the commercial banks as a result of the CD. Indeed, many of the banks today, when they set up the CD's they set up against the scheduled maturities of the CD, municipal bonds, or other securities which automatically provide liquidity. Indeed, in and of itself the CD is a very useful and liquid instrument, because I do not know an instrument that provides for a better projection of needs by scheduled maturities, like the term loan, a very, very useful mechanism providing liquidity through amortization. The CD establishes a scheduled maturity of funds.

Mr. OTTINGER. I would love to go at this further with you, but my time has expired.

The CHAIRMAN. All right. Mr. Harvey?

Mr. HARVEY. Thank you, Mr. Chairman.

Mr. Saxon, I would like to direct your attention for a moment to the Participation Sales Act which passed the House here a week or so ago. Here this morning we are talking about the impact of approximately $17 billion of CD's in the market, and yet a few weeks ago the Treasury Department testified before the Rules Committee that within the next 10 years there could be as many as $50 or $100 billion worth of assets in this, and further within 2 years, as I understand it, over $8 billion of assets will be sold at interest rates of 5 percent or higher.

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What impact will this have on private credit and the home mortgage market, in your judgment?

Mr. SAXON. It will absorb funds available for investment by the commercial banking system and other segments of the financial industry of the country, that is, the sale of these certificates. To that extent it would, of course, displace the use of these funds for other purposes.

On the other hand, you have the question of the extent to which the Government can, given the proper circumstances, move out of direct competition with the private area, and to the extent that it accomplishes this, it would be desirable.

The rate question, it seems to me, is a matter of the relative tightness. As it exists today, I think the tightness has been somewhat exaggerated.

Mr. HARVEY. Well, am I not correct, though, if I understand the first part of your statement, it is going to make the situation we are talking about here even more acute, as the Government sells more of its assets. It is going to absorb a portion of the mortgage market; is that not correct?

Mr. SAXON. That is correct, sir.

Mr. HARVEY. That is correct, and that is precisely—I see Mr. Blackmon nodding his head—that is why his organization so vehemently opposed the participations, because that is what they fear; is that not correct?

Mr. BLACKMON. That is correct.

Mr. SAXON. On the other hand, if I may take a moment, Mr. Harvey, we are a large capital generation economy as you know. Capital generation year by year has been enormous, even though it has not met fully the need, the enormous need, for funds in this country to finance our industrial and commercial growth. But part of this would be taken up, to what extent no one can say, by the normal and continuing increase in the generation of capital.

Mr. HARVEY. Well, assuming what you say in your statement, the theory that you set forth in your statement, to be true, then how do we in Congress go about channeling more money into the homebuilding market? It seems to me that is conspicuous by its absence in your statement. The banking industry is not doing it. The homebuilding industry is suffering very badly as a result of it.

It seems to me that in the housing bills that this Congress has passed in the years that I have been here, we have set that forth as a matter of national intent or of congressional intent, that we wanted to encourage the homebuilding industry. Now something has got to be done to do it. What suggestions do you have?

Mr. SAXON. Mr. Harvey, rather than rely on artificial methods, such as Q or these bills before this committee, if it is the judgment of Congress, as it has been in past years, to give special concern to housing needs, then it ought to be done through legislation providing for Fannie Mae or some other governmental agency or the use of some other governmental technique to provide directly for those needs, so as to impose a minimum interference with the normal operation of the financial mechanism competitively in the country.

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Congress, as I understand it, has done this before in past years. I do not agree with Mr. Blackmon's statement that the housing industry is in a deplorable condition today. Of course I respect you, Mr. Blackmon. I think this industry naturally wishes to see itself expand as others do, and it is entirely dependent on individuals, institutional or the financial industry for its resources to finance building. I get enormous requests.

Mr. HARVEY. Let us be realistic about it. The money is not coming into the housing industry from the banks. It is going into corporate lending. It is going in where they can make more money on it. In fairness to Mr. Blackmon here I think that is true, and I do not think in your statement here this morning or in what you have said you have suggested any cure for it, and I think this committee is concerned about it. I can tell you just having returned from Michigan that in my judgment the homebuilding industry is indeed very critical up there at this time. If you want me to name them, I can give you one project after another that has been stopped or that has not gone forward simply because the money is not there. Savings and loans have just about stopped lending completely. I think this is a very critical situation.

Mr. Blackmon, would you care to comment on this at all?

Mr. BLACKMON. Yes, sir.

As all of us know, the homebuilding industry is one of the basic industries in this country, about the second largest industry. Therefore what happens to it affects the entire economy and the Nation a great deal.

Mr. Saxon, for your information, in the early 1950's we were producing nearly 2 million units a year; we are producing less than 1,500,000 units at this time. There are markets available, but we do not have funds with which to serve these markets.

We have some 4.5 million deteriorating houses in this country. We have 11.5 million substandard houses. Our market is plentiful and could be expanded. But the funds have dried up and it is the one thing that I think concerns this committee.

In past years, the CD has been used as a device for corporate funds with a regular schedule of payments and payments of debt and so forth. Out of the clear blue the Federal Reserve Board changed the entire policy on CD's to allow the CD's to pay more than the savings institutions. It thereby encouraged the flow into commercial banks not only of corporate funds but of all other types of funds—down to $25, on a 30-day basis.

A great deal of money is being artificially channeled not into the housing authority, but into industrial plant expansion.

Certainly when you get a 7-percent investment credit for plant expansion you can pay more for money than you can under normal conditions.

The big problem is that the switch from the established procedure has brought a large amount of money into commercial banks, and they are eagerly investing it in consumer credit. This creates an inflationary spiral and drastically tightens the money supply for the housing industry.

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Mr. HARVEY. Thank you. My time has expired, Mr. Blackmon.
The CHAIRMAN. Yes, sir. Mr. McGrath?
Mr. McGRATH. Thank you, Mr. Chairman.
Mr. Saxon, I understand that there are about $17.5 billion in negotiable CD's outstanding today.
Mr. SAXON. That is correct.
Mr. McGRATH. Do you have any idea as to what percentage of that sum belongs to the 200 largest banks in the country?
Mr. SAXON. I don't have the figures. I will supply them.
Mr. McGRATH. I would be interested in seeing this.
Mr. SAXON. I will supply them.
(The information referred to follows:)

Outstanding negotiable certificates of deposit, by size of bank,[1] May 18, 1966

[Amounts in millions of dollars]

Size of bank	Number of banks	Amount of CD's outstanding	Percent of total
Under $100,000,000	55	$195.1	1.1
$100,000,000 to $200,000,000	51	377.7	2.1
$200,000,000 to $500,000,000	66	1,801.2	10.2
$500,000,000 to $1,000,000,000	41	2,429.4	13.7
$1,000,000,000 or more	30	12,920.3	72.9
Total	243	17,723.7	100.0

[1] Weekly reporting member banks.

Mr. McGRATH. I would also be interested in tracing, if possible, where the great bulk of the increase in the money that has gone into CD's has come from since about 1962, which is the date you referred to.

Mr. SAXON. This is, of course, difficult to determine precisely, but much of the growth has been at the expense of growth in commercial bank demand deposits. These have had very little growth in the past few years.

Mr. McGRATH. Mr. Blackmon, you stated that last year we built about 1.5 million dwelling units in this country. Do you have any idea how many dwelling units we should build each year just to keep even with the increase in families?

Mr. BLACKMON. Of course, all your statistics will show that housing starts to a great extent are related to family formations, taking out, of course, the consideration that during the thirties when the depression was on, and the war when it stopped, and this caused a larger amount of units to be built shortly after the war than the normal family formation.

I think our industry today, in order to provide proper housing for the American families in this country, could easily produce 2 million units a year, and then that would go up as the family formations that are just beginning to be created concerning the World War II babies, that would continue to rise. But with a normal year of 1.5 million units, we are down considerably, and our starts will even show a greater decline, as Congressman Harvey has brought out, as soon as

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those statistics start being revealed in August probably, September, October, and November.

But we could usually take 1.5 million regular units and 500,000 units of these substandards to better house America very easily. We have the manpower, we have the materials available. One of the biggest problems is the money.

Mr. SAXON. I would like to comment on that. This again gets back to the question as to whether in this period, with the inflationary pressures that exist, this one industry and this alone should be freed entirely of the normal operation of restrictions that are being imposed on other segments of industry. I just find no basis for it, that there must be a certain given natural increase each year in the creation of housing.

Incidentally it isn't all individual housing, although naturally this association would base it on this basis. Much of the construction we are talking about, and one of the larger uses of funds represents large substantial construction, office buildings and the rest of this. You can see it if you go through Maryland and Virginia, unused capacity here in this area, the expansion here in the District of Columbia, the projected expansion which is very substantial. This absorbs funds. All of this is involved in the picture.

I think it is misleading to accept this on the basis that you are depriving an individual family of a home alone. There are other very substantial promoters, project promoters, office buildings and other large developers which have obviously a very substantial interest in a continued expansion, and apparently without regard to the general economic condition of the country and the inflationary forces that exist, and that today ought to be restrained.

Mr. OTTINGER. Would the gentleman yield?

Mr. MCGRATH. I yield.

Mr. OTTINGER. I think we are very concerned not to be pumping new money into the economy as you suggest might be a solution, by supplying additional money through Fannie Mae into the savings bank and home loan industry. What we are concerned with is the fair distribution of credit to all institutions under a policy of monetary restraint.

What we are saying is that the real pinch from our policy of monetary restraint has been felt in the home loan business, whereas through the device of the CD's, the commercial segment of the economy is allowed to expand in a virtually unrestrained manner. We would just like to see a restoration of some equity between these two segments of the financial economy.

You don't have a situation today where the home loan industry is going wild with credit and with funds. It seems to me you have just the reverse situation, where the funds are being let out freely to the commercial world through the instrument of the CD's while the home loan industry is being pinched very severely through the drain of funds from the traditional source, which is the small thrift depositor.

The CHAIRMAN. I suggest that we will have to confine our questioning to about 2 or 3 minutes in order for all the members to ask questions.

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Mr. McGRATH. Just one more question, Mr. Chairman.

The CHAIRMAN. Yes. We have Mr. Hansen and Mr. Annunzio, Mr. Rees and Mr. Mize.

Mr. McGRATH. Mr. Saxon, do you have any figures on how many CD's savings and loan associations themselves hold in total amount? Are they in this market as holders of CD's, do you know?

Mr. SAXON. Yes.

Mr. McGRATH. In a significant manner?

Mr. SAXON. They have been a very substantial factor in this, which is a critical question. As of April 26, 1965, they held over $975 million in CD's. If the funds are being used as aggressively as is being suggested for housing construction, by that I would include very large scale construction too, then how could these funds be placed so widely in commercial banking institutions?

Now the recent regulation of the Home Loan Bank Board reducing liquidity requirements from 7 to 6 percent, and withdrawing the authority to include as part of the liquidity, CD's in commercial banks, is going to have a substantial impact. This is a critical question.

The CHAIRMAN. Mr. Hansen?

Mr. HANSEN. Thank you, Mr. Chairman.

Mr. Saxon, going back to the line of reasoning that was used in your discussion with Mr. Ottinger, it appears that the intent which preceded the change in regulation Q on the part of the Federal Reserve banks has not come to fruition. In other words, by way of the high interest rate on CD's, there hasn't been as much restraint placed on the banking industry as there has been on the building and loan industry, because of the transfer of funds.

What in your opinion would have been the effect, had they let the interest rate stand and increased the reserve requirements?

Mr. SAXON. I think we would have had a substantial additional interference in connection with the international balance-of-payments problem we face. Regulation Q was one of the factors primarily responsible for the creation of the Euro-dollar market. It is a serious matter. The change in Q was not alone a matter of trying to give the banks flexibility in competing for funds. It was also to provide some mechanism for the banks to compete internationally in the way of retaining funds in terms of their effect on the money markets.

I think it would have been unfortunate if the Fed had not moved, or had moved very late to achieve a permitting of some flexibility here. I don't believe this outflow from the savings and loans has gone all to the banks by any means, Mr. Hansen. I don't think this can be demonstrated. A lot of this is sensitive money. A lot of this California money came from the East; definitely hot money.

A lot of it, much of it up to the $100,000 area deposited and above, has gone into the stock market, I presume, and to other financial instruments.

This type of restraint that is here proposed, if it is actually adopted we would find quite naturally that this type of person, this investor or

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depositor, if we may characterize him as such, can put his money into Treasury securities now at 5, into agency securities at 5.5, in any other number of instrumentalities, so I don't think the outflow has been by any means entirely to the banks.

Mr. HANSEN. In your judgment this should have been started sooner.

Mr. SAXON. I think if it had, Mr. Hansen, we would have seen a better relationship in the money market.

Mr. HANSEN. Thank you.

The CHAIRMAN. If we have the executive session at 11:30 which we have agreed upon, then we will have to restrict the individual questions to about 2 minutes each. Would it be all right, Mr. Saxon and Mr. Blackmon, for the members to submit questions in writing for you to answer when you look over your transcripts?

Mr. BLACKMON. Certainly.

The CHAIRMAN. Then the witnesses may extend their remarks to expand on anything they desire to. Next is Mr. Stanton.

Mr. STANTON. Thank you, Mr. Chairman.

Mr. Saxon, there is not too much you can be asked in a couple of minutes. You do a beautiful job of presenting the bank picture, and you do a beautiful job of presenting the picture for unrestricted regulation in this country.

As Mr. Harvey said, we are interested in this particular bill, as to its effect on the homebuilding industry. Not necessarily the savings and loan industry itself.

Your statement, as you said, went through a period of unfair competition as to banks. But in relation to this, don't you think we will see a phasing out of the passbook as a means of savings, if we continue the unrestricted use of CD's?

Mr. SAXON. So far we don't observe any substantial indication in this direction. In many areas, in my own area in the Middle West, in Pennsylvania, in a number of districts the CD has been the traditional reliance for the small saver, rather than the savings deposits. They have been issued for generations and generations, the nonnegotiable CD.

So apart from those areas where CD has been used in place of the savings deposit, while we may see more of a change in the future, so far we haven't. We now have and have had for many years large amounts of nonnegotiable CD's. I think some $18 to $20 billion are outstanding now. They have been large for a long time.

Mr. STANTON. Mr. Chairman, I have reference here to this full page ad sent me which appeared in a Columbus, Ohio, paper recently advertising the investors guaranteed savings bonds, and I would like to submit it for the record because it is a change in our part of the country from the historic passbook savings, to something entirely different.

The CHAIRMAN. Without objection, you may insert it in the record at this point.

(The advertisement referred to follows:)

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[From the Columbus (Ohio) Citizen-Journal, May 24, 1966]

Here are some striking figures, lifted from a new market study conducted by U.S. News and World Report. The survey was sponsored by Life Insurance Agency Management Assn. But the results are important to everyone who saves or invests money.

Here's what people say they do about saving and investing money.

See how you compare with other people buying life insurance.

- 93% have checking accounts
- 78% have savings accounts
- 39% own Government Bonds
- 26% are stockholders
- 13% have mutual funds

76% of the people said they plan to do more saving in the next few years.

- 26% would consider life insurance
- 25% named common stocks
- 22% would buy Government Bonds
- 13% would include mutual funds
- 67% planned to put more in savings accounts

Now, the point is this. Everyone is interested in making their money go farther, work harder, and getting a better return on it. And good family money management requires a balance between the protection of life insurance, the potential growth of stocks and bonds, and the guaranteed security and high return of bank savings. You need them all.

The backbone — the bedrock of making your money grow, is money in the bank. It's rock solid and safe. You can lay your hands on it when you need it. And it grows. For example: $5,000 in our 4½% Investor Saver Bonds will grow to $6,255 in five years. And we guarantee it.

Our Investor Saver Program has become one of the most popular ways to save money at a guaranteed high rate of return. So, if you are carefully planning your family's future, Bank savings should be the foundation. The best way to build that foundation is with Investor Saver 4½% Bonds.

Incidentally, in the survey almost half of the people questioned said that they needed a plan that forced them to save regularly. We have the answer to that, too. Stop at any office and ask about our Investor Save-O-Matic plan. It works great.

Investor Saver Bonds are proving to be Central Ohio's most popular new savings plan. Here are 10 special advantages.

1 — Earn a guaranteed return of 4½%
2 — Rate is guaranteed for 5 years
3 — Interest starts immediately
4 — Insured by F.D.I.C.
5 — Can be cashed after 90 days
6 — Available in practically any amount
7 — Start at $19.99
8 — Intangible Tax paid for
9 — Can be assigned, used as gifts
10 — Interest check mailed monthly, quarterly, or semi-annually

Use this Order form to become an Investor Saver Bond owner... or visit any City National office

INVESTOR SAVER BONDS ORDER FORM

Complete this form and mail to: CITY NATIONAL BANK, P. O. BOX 1347, Columbus, Ohio 43216

SAVINGS BONDS

No. Bonds	Cost	Total
______	$ 25.00 @ $19.99	$ ______
______	$ 50.00 @ $39.98	$ ______
______	$100.00 @ $79.95	$ ______
	TOTAL	$ ______

GROWTH BONDS

No. Bonds	Denominations	Total
______	$ ______	$ ______

INCOME BONDS

No. Bonds	Denominations	Total
______	$ ______	$ ______

Interest Check to be Mailed to Me
☐ Monthly ☐ Quarterly ☐ Semi-Annually

Enclosed check payable to City National Bank for the total amount of $ ______

Issue Bonds in the name of: ______

(City) (State) (Zip Code)

Social Security No. ______

Name of Purchaser (PLEASE PRINT)

Address of Purchaser (Street, City, State)

INVESTOR IS 4½% SAVER BONDS

IMPORTANT: BONDS WILL BE MAILED TO PURCHASER BY RETURN MAIL.

To Invest - and Earn More - the answer IS

City National
BANK AND TRUST COMPANY OF COLUMBUS, OHIO

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Mr. STANTON. Another question, Mr. Saxon. Do you have any knowledge, with this particular change in trend in the last couple of years, in the last 6 months in general, of a shift of request for bank charters from savings and loan industries who maybe see the handwriting on the wall, with this unrestricted competition and the desire of the savings and loans to get into the banking field, or is there a merger element?

Mr. SAXON. We have had one conversion, a stock charter association in Ohio, a very good institution. We have had a number of inquiries from other institutions, stock savings and loan associations.

I don't think this is unhealthy or improper, if an institution wants to move in one way or another. So long as it is sound, I think we should give fair consideration as we did in the Ohio case.

We haven't approved any since then, but if we had an application by a good, well-rounded association who would wish to convert, we would do so. I don't read it necessarily at this juncture at least as suggesting any general trend, but I think this type of convertibility is not unhealthy.

Mr. STANTON. Thank you very much.

The CHAIRMAN. Mr. Annunzio. I am sorry we are so pressed for time.

Mr. ANNUNZIO. Thank you. My time is limited, Mr. Saxon. On page 1 of your testimony I was very much interested in your statement, and I would like for you to elaborate further.

When the Government intervenes to fix prices, administrative decisions are substituted for the market price. The decisions of one man or a few men replace the judgments of many.

I think that the Congress and the Congressmen have been lax in their responsibilities as far as the agencies are concerned, and I am happy to read your statement. The Congress should have been more responsible in regulating these agencies instead of being independent of each other, getting them more or less to work together with the elected head of our Government, the President of the United States.

I would like to have you further elaborate on this statement. My time is limited, and consequently I am interested in your views, because we are all in agreement, whether it is the building industry, yourself, or the Secretary of the Treasury and even some members of the Federal Reserve Board, in that when the Federal Reserve Board did act in December, no one knew about it, so that we are all members of the same club.

Mr. SAXON. Yes.

The CHAIRMAN. Mr. Rees.

Mr. ANNUNZIO. Pardon me, Mr. Chairman. I wanted to get his reaction. Just what did you mean? My 2 minutes are not up yet.

Mr. SAXON. We are referring there to regulation Q as a prime example of price fixing.

Mr. ANNUNZIO. What did you mean by replacing the judgment of many? Are you agreeing with us that we should have a lot of men at these discussions, at least the elected representatives of the people?

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Mr. SAXON. It would have been very helpful if we had known in advance of the change in regulation Q.

Mr. ANNUNZIO. Thank you.

The CHAIRMAN. Mr. Rees.

Mr. REES. Thank you, Mr. Chairman.

Mr. Saxon, you have been talking about competition. I have discussed this problem with the Federal Home Loan Bank Board several weeks ago before their decision in lowering the liquidity and raising the interest rates.

I am from California, which is a State that needs money. We are expanding. What would you think of changing the regulations in the Federal Home Loan Bank Board, which would increase the liquidity as you suggested up to 15 percent, and then allowing them to compete in terms of interest rates? Now they are, in reality, regulated. They can't draw down the 17 percent, if they don't do as the Board wants them to.

Mr. SAXON. That is correct.

Mr. REES. As you know, an administrative agency can really harass an institution, if they decide they want to. This would give you competition.

Mr. SAXON. Yes. It has differing effects. While it is designed to impose restraints on some, in the process very well run institutions are proscribed, limited necessarily as a result of this particular type of regulation.

I am not so sure that this whole package was a very desirable package. Indeed in a period like this in some of the additional restraints I am posing additional restrictions on banks and holding companies in this instance, I don't know whether this is desirable either. There are other aspects of this problem.

Mr. REES. Mr. Blackmon suggested, and this has been suggested in these hearings, that there be established probably by statute a coordinating group, which would coordinate the Federal Home Loan Bank Board, the Federal Reserve Board, your office, Treasury and whoever else might be affected, so that there might be at least some discussion in terms of unilateral discussions being made by any individual agency which would affect another agency.

Mr. SAXON. I think this is very desirable, Mr. Rees. It would carry us back to where we were in 1935 when the Secretary of the Treasury and the Comptroller of the Currency sat on the Federal Reserve Board and participated in these decisions.

As it is today, on some grounds of supposed threat to independence, they are excluded. I am not speaking for the Secretary now. I am just speaking for myself, but I think this is meritorious.

Mr. REES. I introduced a bill which would define a certificate of deposit. I consider the CD to be a dangerous instrument, when used by bankers like Mr. Silverthorn of San Francisco, in terms of liquidity.

The bill provides that the certificate of deposit must have at least a 1-year maturing and would not be able to draw any more interest than the passbook rate of the bank. What would you think of that type of bill, from the point of view of CD?

Mr. SAXON. I think it would introduce further rigidities into an already highly complicated structure. It could well be harmful. In-

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stead of providing some protection for the savings and loans, it could well end up in providing additional difficulty for them. I think it might well give false comfort.

Mr. REES. What about the dilemma of the certificate of deposit. I think we found last December before the Board made the decision to raise rule Q that this is a rigidity, it does affect the liquidity of a bank?

All of a sudden, if the CD's were to leave, it would put many banks in receivership. Isn't there some way that we can regulate the CD in terms of building up reserves behind it or by providing that you can only have so much in CD's in terms of your total investments?

This is a problem we are having in California, as you know, from a lot of smaller banks that have been forced to merge because of the problem of CD's and liquidity.

Mr. SAXON. I think we are out of that now as far as I am aware in California. Most of these CD's in the smaller institutions which were disproportionate to their structure have since been liquidated.

We met the problem in the case of the smaller banks generally throughout the country, as I indicated in response to a question from Mr. Todd by requiring our examiners to appraise each one of these situations individually, and to limit or proscribe, any deposit from outside the immediate trade area of the small bank.

In the case of the larger banks, we have got to presume as I do that large New York City and Chicago banks have, as I am sure they do have, the financial sophistication to manage their money well, and if they can't, we are indeed in trouble. But I know they can.

I think it is a differentiation between institutions. This applies to the savings and loan industry. Many of them are careful and prudent and well-run institutions. There are some certain areas, such as California, where it is very difficult.

Mr. REES. Thank you.

The CHAIRMAN. Mr. Mize?

Mr. MIZE. Thank you, Mr. Chairman.

Mr. Saxon, Mr. Mitchell of the Federal Reserve Board last week said that he felt some large New York and Chicago banks were actually using these 5.5 CD's as a kind of a loss leader, and they were borrowing money at 5.5 percent and lending it at 5.5 percent and actually losing money. Do your examiners find that to be the case?

Mr. SAXON. I think the references to the press, in the use of such terms as chasing dollars and the implications that the amount of money that is changing hands and being taken at this rate is large, I don't think these comments are well founded.

Mr. MIZE. Mr. Rees has described his bill. Now you know Mr. Patman's bill would outlaw negotiable CD's entirely. Mr. Ottinger's bill would limit the denomination size to $15,000. Which of the three bills would you accept, or do you not like all of them?

Mr. SAXON. I would accept anything that Congress enacted. That is point one.

Mr. MIZE. I know.

Mr. SAXON. The CD is a good and useful instrument. It has been used for many many years, both the negotiable and the nonnegotiable CD.

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Now abuse may occur from time to time. We have attempted to deal with that, and I think effectively, by directions to our examiners. The power is ample to do so.

But the instrument itself inherently is a very sound and useful tool and has been for many, many years, and I would hate to see some action taken to cure as ephemeral a problem to the extent that such problem exists, by the adoption of rigidities and restraints which could have in the long run very seriously harmful effects.

In fact, we have more than ample power to deal with any situation today where we see an excess amount, and we are doing it wherever we see it. Where we see an excessive amount of CD's in relation to the total deposit structure, we have the authority and do cut it back.

It is a uniform rule now with respect to the smaller banks, and we are using it in other areas, and we are planning more and more care and prudence in the handling of the CD's by the larger banks too as years go on.

Mr. ANNUNZIO. Will the gentleman yield?

Mr. MIZE. If the Chairman will grant me any more time.

Mr. ANNUNZIO. Mr. Saxon, will you answer Mr. Mize's question on the comments made by Mr. Mitchell of the Federal Reserve Board, that on these CD's, 5.5 percent, that actually the big banks are taking this money and losing money by paying out 5.5 percent?

The CHAIRMAN. Answer it for the record, please.

Mr. ANNUNZIO. Answer it for the record.

(The information referred to follows:)

REPLY OF HON. JAMES J. SAXON, COMPTROLLER OF THE CURRENCY

I would not characterize the issuance of 5.5-percent CD's as a "loss leader." It is true that considered as a permanent source of funds, 5.5-percent CD's would be only, marginally profitable but two facts must be kept in mind:

(1) The amount of CD's issued at this rate is not very large.

(2) The availability of the CD instrument allows large banks to meet liquidity needs by issuing such certificates. It is liquidity rather than earnings considerations which are paramount.

ADDITIONAL STATEMENT BY LARRY BLACKMON, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Under the permission of the chairman to extend my remarks I am impelled to point out that the opposition, voiced by the Comptroller of the Currency Saxon and others primarily interested in the commercial banking system, to any attempt to restrict certificates of deposit leaves completely unanswered the following questions of vital interest to the American homebuilding industry:

(1) If the present flow of funds from savings institutions into commercial banks continues, where will permanent residential mortgage financing come from?

(2) With mortgage financing for its customers scarcer than at any time in recent history, how can the homebuilding industry perform the job, which the Congress has assigned to it and the American public expects of it, of expanding the supply of housing for low- and moderate-income families?

(3) With the "unrestricted competition for savings" advocated by Mr. Saxon, how can we avoid return to the pattern of 40 years ago when the majority of the industry's production was concentrated in price brackets which only families of high income could afford?

(4) If the purpose of the virtual nullification of regulation Q was anti-inflationary, how is such objective served by diversion of billions of dollars from residential mortgages into high-yield consumer financing?

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The homebuilding industry does not mind curtailment to serve a national good; it objects most strenuously to being asked to bear practically the entire burden of so-called anti-inflationary moves which, insofar as we can observe, have served merely to stimulate bank lending and bank profits while failing (as history proves they must) to cool an overheated economy.

I call the attention of the committee to an excellent statement of views with which we agree, contained in a letter from John E. Horne, Chairman, Federal Home Loan Bank Board, printed in the Washington Post for Tuesday, May 31, 1966 (copy attached).

Attached also are two typical illustrations of the vigor with which commerical banks are seeking (unfortunately, successfully) to attract long-term savings.

[From the Washington Post, May 31, 1966]

FOR THE SMALLER SAVER

Readers of your May 21 editorial "Split Levels for S&Ls" may be impressed by the fact that the article contains a number of points to which most reasonable people might subscribe. Nevertheless, the editorial may be misleading because it omits consideration of the effects of massive shifts of funds among financial institutions in a short period of time.

Your editorial ignores the fact that the banking system has long maintained, by regulation, two sets of rates, one for small savers and one for large savers. For many years the small saver received the higher rate, but beginning in late 1964 banks were granted the authority to pay the large saver, usually an organization not eligible to hold a passbook savings account, a higher rate on the grounds that it was necessary in order to stem the flow abroad of corporate and other large deposits. Thus the holder of a certificate of deposit began to receive a rate higher than the individual who used a savings passbook.

A few ingenious banks, finding that there was no explicit prohibition against issuing small certificates of deposit, began to offer certificates in small denominations, even as little as $25, at a rate above that for the savings passbook. Since December of last year they have been able to offer rates as high as 5½ percent through this device to persons who would ordinarily be passbook savers.

Banks had ordinarily issued certificates of deposit only in large amounts; but now that the certificate was eligible for a rate higher than the passbook, it suddenly became a consumer savings instrument. Testimony before Congress shows that the Federal Reserve did not intend to disturb the relationship among institutions for consumer savings accounts.

Furthermore, rapid mass shifts of funds in a short period of time from a specialized set of financial institutions, confined to one market, to a generalized set of financial institutions can lead to quite undesirable effects. Let me make it clear that the loss of a substantial amount of funds in April from the savings and loan associations is not likely to affect their soundness. However, their ability to serve the mortgage market has been reduced far more substantially than most would consider desirable.

Nor is it evident that massive shifts of funds to banks is helpful in any way. We know that not all resources are readily transferable, and sharp reductions in the use of resources in residential building is not likely to satisfy demand elsewhere. What is more, the banks have increasingly concentrated their lending in the last year in commercial and industrial loans, which by their very nature move into inventory and plant and equipment. In both these areas there is ample evidence of overheating.

As for the small saver, the institutions which the Federal Home Loan Bank Board regulates have offered him the best rate of return on deposit-type savings for many years. Even today, except for the certificate of deposit instrument, savings and loan associations offer a higher rate than banks in most places. In any event, the small saver should not be used as an excuse for preserving a contrivance which can seriously distort flows of funds and which makes a travesty out of the reasoning underlying the 5.5 percent rate on certificates.

It would seem, therefore, that your editorial runs the risk of slavish endorsement of what appears to be competition but really reflects an artificial device contrived because our laws are not explicit. I think it is within this framework that Secretary Fowler's position as well as that of others should be judged.

JOHN E. HORNE,
Chairman, Federal Home Loan Bank Board.

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GROWTH			

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THE WALL STREET JOURNAL
Friday, May 27, 1966

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THE WALL STREET JOURNAL, Friday, May 27, 1966

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The CHAIRMAN. Now Mr. Blackmon wants about 1 minute on a question he brought up in the beginning. Then we will have an executive session. Mr. Blackmon.

Mr. BLACKMON. Mr. Chairman and members of the committee, since appearing before you the last time, there has been a problem created in our industry that I would like to bring to your attention. The borrowing authority of Fannie Mae to finance its secondary market operations is presently restricted to 10 times its capitalization and surplus. Because FNMA is purchasing loans at the rate of $40 to $50 million a week, it is quickly reaching its statutory limit. As a result, it has restricted its purchase to a $15,000 limit. This limit throws a burden on high cost areas in the country, in the West and in other parts of the country. For this reason I think some action should be taken quickly to increase Fannie Mae's borrowing authority.

Our board of directors last month recommended that this authority be increased from 10 to 1 to 20 to 1. I understand you have two bills before you, one from Mr. Hanna, increasing it to 15 to 1, and one from Congressman Widnall increasing the authority of Fannie Mae on an outright basis by $1.1 billion. We believe it is a matter for Congress to determine the more feasible approach.

(The following information was submitted for the record:)

ADDITIONAL REMARKS OF MR. BLACKMON

As this committee is no doubt well aware, the mortgage money crisis of recent months has highlighted the reliance of the homebuilding industry on FNMA's private secondary market. Recently, FNMA has been purchasing mortgages at levels from $40 to $45 million per week. This heavy volume has caused considerable drain on FNMA's borrowing capacity—currently set at 10 times capital and surplus.

At current rates of use, it is likely that FNMA will have exhausted its borrowing capacity for its private secondary market operations some time this summer. It should be emphasized that these operations are carried on at no cost to the U.S. taxpayer.

At our board of directors meeting 6 weeks ago our members expressed considerable concern about this problem and what failure to meet it would do to the homebuilding industry, already operating under severe strain and dislocation as a result of current monetary policy.

After much study and discussion, our members adopted a resolution calling for doubling FNMA's borrowing power. It was our hope and expectation that this important Federal agency could be given sufficient authority to enable it to continue to provide the secondary market backup and flexibility which has been so important a part of the homebuilding financing machinery in recent years.

It was our board's feeling that FNMA needs at least double its current borrowing authority, if it is to operate without artificial restrictions, and that anything less would result in recurrent crisis during the coming year.

I am at a loss to understand why no recommendation has been forthcoming from the executive branch to the Congress about this critical situation.

It is my understanding that the Housing Subcommittee of the House Banking and Currency Committee is considering a number of approaches that would alleviate this problem by increasing FNMA's borrowing capacity without any eventual real cost to the U.S. taxpayer.

One approach, sponsored by Congressman Hanna, that of increasing the borrowing capacity from 10 to 15 times capital and surplus would, we have been told, create some legal questions about the rights of prior debenture holders. The second, sponsored by Congressman Widnall, which would have the merit of not casting legal shadows on FNMA operations, would increase the Treasury preferred stock by $110 million and the borrowing capacity by over $1.2 billion. At FNMA's current level of activity this may not last the full year and might require coming back to the Congress again for additional funds.

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We have every confidence both in the judgment of the subcommittee, under the able chairmanship of Congressman William Barrett, to select the most logical approach, and, in the wisdom of the Congress to legislate the soundest method.

We are grateful to both Congressman Widnall and Congressman Hanna for their sincere efforts to solve this problem.

It is, of course, inconceivable to us in the homebuilding industry, that appropriate steps would not be taken to allow FNMA to continue to perform, without artificial restraints, the vital functions set forth in its charter. At the present time, in order to preserve its currently limited borrowing authority, FNMA is refusing to buy mortgages valued over $15,000. This action is discriminatory against many areas of the country, particularly the north and the west where higher labor and land costs make it difficult to provide much housing for the market under such a restriction.

These are times of money crisis and shortages for essential business. FNMA's creators envisaged that it was at just such times the agency would be of the greatest usefulness. It has been able to do so in the past, when its borrowing capacity was adequate.

It would be disastrous to the small businessmen represented in the homebuilding industry if the agency were not again able to perform that function during the months ahead.

The CHAIRMAN. I would like to ask each one of you gentlemen this one question without further comment.

There is a proposal that we permit interest on deposits of under $100,000 at a 4.5-percent rate and permit interest on deposits of $100,000 and over to be at the rate prescribed under regulation Q. Would you be inclined to favor that, Mr. Saxon, or would you be opposed to it?

Mr. SAXON. I would be opposed to it, Mr. Chairman.

The CHAIRMAN. How would you stand, Mr. Blackmon, on this question?

Mr. BLACKMON. We feel that CD's should have guidelines, and we favor any guidelines that this committee might set.

The CHAIRMAN. You think this would absolutely relieve the situation?

Mr. BLACKMON. I don't think it would relieve it completely, but I think guidelines would be helpful.

The CHAIRMAN. It would be helpful in the present situation?

Mr. BLACKMON. Yes, sir.

The CHAIRMAN. Would it be more helpful in any of these bills if there was a smaller amount than that? You would like to have it as large as possible, wouldn't you?

Mr. BLACKMON. Our board passed a resolution that it should not be lower than $25,000.

The CHAIRMAN. Well, would you consider a $100,000 minimum adequate?

Mr. BLACKMON. Certainly.

The CHAIRMAN. Thank you very much, gentlemen, for your attendance here. We will have an executive session in 2 minutes, and shall reconvene at 10 a.m. tomorrow.

(Whereupon, at 11:30 a.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, June 1, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

WEDNESDAY, JUNE 1, 1966

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, St Germain, Weltner, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Halpern, Johnson, and Mize.

The CHAIRMAN. The committee will please come to order.

This morning the committee continues hearing testimony on H.R. 14026, to correct abuses related to certificates of deposit.

We are very pleased to have as our witnesses three academic economists to give their views on the CD problem. The large negotiable CD is a money market phenomenon which has been the subject of much debate since its origination in 1960. Certainly, the large negotiable CD, though containing the word deposit in its name, is not a bona fide deposit at all—on that the testimony before our committee is crystal clear. It is a money market instrument designed to attract the extremely volatile short-term cash balances of large corporations.

Nearly everyone agrees that the CD situation has gotten out of hand, not just from the standpoint of competition, but as a problem for the banks themselves as they attempt to keep this hot money. But no one has come up with a precise diagnosis and a course of treatment for these giant financial patients of ours.

So we are hopeful Doctors Rousseas, Klebaner, and Carson will all contribute valuable suggestions as well as analysis.

I assume each of you gentlemen has a prepared statement. In any case, I suggest that in the course of your testimony you all touch on the very interesting remark by Comptroller of the Currency Saxon on May 25, in Atlantic City, that the large money market national banks depend on renewing these large CD's, that otherwise serious liquidity problems will result. This is a very disturbing remark and all members of this committee have a special responsibility to be concerned and to find out all we can about this shocking state of affairs in our banking system.

Mr. Rousseas, would you take about 10 minutes and summarize your statement, and then Mr. Klebaner and Mr. Carson. Then the members of the committee would like to ask you questions.

All right, Mr. Rousseas.

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STATEMENT OF STEPHEN W. ROUSSEAS, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY

Mr. ROUSSEAS. Mr. Chairman, I will summarize the statement that I have submitted in writing to this committee.

The CHAIRMAN. We will put all three statements in the record after each one's oral statement.

Mr. ROUSSEAS. In my testimony, I will not attempt to disentangle the claims and counterclaims of CD's with respect to thrift institutions. My own interest lies in the implications of CD's for monetary policy, and with the Federal Reserve Board's actions in that connection.

One of my concerns has been in the postwar short-run changes induced in the income velocity of money and their bearing on the effectiveness of monetary policy.

It seems to me CD's are a very unique money market instrument. Not only are they high-priced money, they are the only money market instrument which is issued directly by the commercial banks themselves.

Without going into any detailed balance-sheet analysis I have tried to indicate, in my written testimony, that shifts from demand to time deposits within the commercial banking system results in an increase in velocity, given the differences in reserve requirements for these different types of deposits. This very same phenomenon would occur if funds were to drift from passbook and time deposits of savings banks and loan associations into commercial bank time deposits, since by and large these thrift institutions do keep a significant part of their reserves in the form of demand deposits with the commercial banking system.

I have also tried to indicate that when nonbank corporations—which hold about 70 percent of the negotiable CD's—switch out of Treasury bills and into CD's, this also, results in increase in the income velocity of money assuming that the Treasury will not retire any debt.

In my statement I refer to the Federal Reserve Bank of New York's claim that they are the ones who invented and thought of the idea of CD's; that a former vice president of the Federal Reserve Bank of New York made the first public statement on CD's and that the First National City Bank of New York first issued them in 1961 and arranged at the same time, for a secondary market in negotiable CD's.

The CHAIRMAN. I do not understand how this would be correct when they had over a billion dollars of CD's outstanding in 1960.

Mr. ROUSSEAS. My understanding is that certificates of deposit had existed in the Southwest and in California, but they were not negotiable and that consequently there was no secondary market for CD's. I may be wrong on this. But my understanding is that negotiable CD's began in 1961, about February of 1961.

Certificates of deposit had, of course, existed earlier than that but we are now talking about CD's as a new kind of money market instrument. And I think this dates back to about January or February of 1961. The First National City Bank of New York was the innovator and arranged with a dealer in Government securities for the simultaneous creation of a secondary market for CD's of a very high denomination, in the million dollar category, I believe.

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My own position is that Federal Reserve Bank of New York is involved in a slight inconsistency. It takes pride in having fathered CD's and then, says that if excess reserves and velocity changes are generated (given the differences in reserve requirements between demand and time deposits), it can undertake the necessary counteracting open market operations.

I want to focus my testimony on this particular aspect of the Federal Reserve's position.

It should be pointed out that in the early 1950's the Federal Reserve Bank of New York, under the distinguished leadership of Allan Sproul and Robert V. Roosa, was the major supporter of what is now called the "new" monetary policy. This "new" monetary policy shifted the emphasis of monetary control over to the supply side and argued that with the emergence of the very large public debt, as a result of the Second World War, large, yield-conscious, conservative, nonbank financial intermediaries could easily be locked into it by very small changes in interest rates via the open market operations of the Federal Reserve System.

Now, it seems to me that in the postwar period, and especially since 1955 when monetary policy has really been applied in the modern sense, the range of interest rate variation has been very large indeed. And velocity changes have also been extraordinarily large. As a matter of fact, I think many economists are rather perplexed as to whether a velocity maximum exists at all. Empirical data indicates we have not yet reached it. I think the last calculation for velocity in the first quarter of 1966 would bring us to a slightly over 4.2 rate of turnover of the money supply.

The problem, as I see it. is this: if the Federal Reserve System takes pride in having fathered CD's and CD's result in velocity changes, then the counteracting open market operations of the central bank, contrary to the "new" monetary policy, will have to become progressively larger and larger.

I cannot, in the time allotted to me, get into any detailed analysis of these velocity changes. There is considerable disagreement about them from a policy point of view and I have submitted to the staff of this committee some supporting material which will present my own views on this issue.

With respect to the bills now before this committee, I would like to pay special attention to section 1 of Mr. Rees' bill, H.R. 15173, which would prohibit insured banks from issuing negotiable CD's and unsecured notes. I favor this part of Mr. Rees' bill. I find, however, that I do not understand the reasoning behind section 2 of H.R. 15173 since I do feel that some spread in interest rates is justified between passbook savings and nonnegotiable time deposits.

Apparently, most of the bills now before this committee are concerned with the impact of CD's on thrift institutions. My own concern, however, is with the monetary policy implications of negotiable CD's and high-cost time deposits. From this point of view, I would suggest abolishing the distinction between city and country banks and requiring a uniform legal reserve ratio for all demand and time deposits. This would strengthen monetary policy by severely limiting the power of the banks to generate excess reserves through a reduction of their total required reserves.

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I should like to point out that the unique characteristic of CD's is that they increase excess reserves by reducing the required reserves of the commercial banking system.

The proposal which I am now making would also serve to lessen the pressure on thrift institutions, for commercial banks would not be willing to encourage the inflow of high-cost money if their excess reserves were not affected. Perhaps, this approach is to be preferred even to section 1 of H.R. 15173. It would achieve the same ends while at the same time contributing to the effectiveness of monetary policy.

As for the velocity changes attributable to the dumping of Treasury bills by the banks, a standby supplementary reserve requirement administered by the Federal Reserve System would also be in order.

I would like to conclude my comments by saying that I would regard the committee's bills and my own proposal as a patchwork approach to a serious problem. I think it is time we took a good look at commercial banks and their relation to the Federal Reserve System. We might also consider at the same time how we might improve upon the Federal Reserve System so as to increase its power and authority to regulate the flow of credit and decrease the influence of the commercial banking system on its actions.

With regard to this last part of my statement, I have in mind the accommodating changes in regulation Q by the Board of Governors every time the commercial banking system finds itself in a liquidity squeeze, and I am raising the question as to whether the Federal Reserve System has not to some appreciable degree lost its initiative in determining monetary policy.

Thank you, Mr. Chairman.

(In a letter to the committee, dated June 15, 1966, Professor Rousseas submitted the following information:)

It has come to my attention that the Board of Governors was on the phone the next day to the Federal Reserve Bank of New York demanding to know if my testimony was correct that the New York bank had taken credit for "inventing" CD's. The public information officer of the New York bank explained that President Hayes had made such a claim, but before a closed meeting of the American Banking Association in Atlantic City. The fact, however, that the New York bank subsequently circulated a copy of President Haye's remarks in mimeographed form did constitute a public disclosure.

(The complete statement of Professor Rousseas follows:)

STATEMENT OF STEPHEN W. ROUSSEAS, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY

Mr. Chairman, I have read some of the testimony given before this committee and I feel the issues have been fairly presented and clearly joined. I shall not try to disentangle the claims and counterclaims that have been made concerning negotiable certificates of deposit with regard to interbank competition, their impact on thrift institutions or, for that matter, on the earnings and liquidity changes of the commercial banking system. Nor shall I burden you with any detailed statistical analysis of the phenomenal rise in negotiable CD's as a money market instrument since their introduction in 1961 by the First National City Bank of New York. Knowledge of these developments will be taken for granted as will the periodic changes in regulation Q which are at the bottom of the problem under consideration by this committee. My testimony will be concerned, instead, with the broader implications of this new money market instrument from the point of view of monetary policy and the short-run changes induced in the income velocity of money; i.e., in the average rate of turnover of the money supply as conventionally defined in terms of currency in circulation plus adjusted demand deposits.

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CD's, as is well known, are high-priced money. But apart from this they are a unique money market instrument. Unlike Treasury bills and open market commercial paper, CD's are issued by the commercial banking system itself. For example, nonbank transactions in Treasury bills involve an exchange of demand deposits; they do not affect the reserve position of the commercial banking system as a whole. But banks are part of all primary transactions in CD's, and the uniqueness of CD's lies in the fact that they involve a switch from demand to time deposits within the commercial banking system.

In all of this discussion it must be kept firmly in mind that of the many types of financial intermediaries, commercial banks alone have the power to create money under a fractional reserve banking system. The importance of CD's can perhaps best be understood by comparing them with Treasury bills. Ever since the Treasury-Federal Reserve accord of March 1951, banks have resisted pressure on their reserve positions. During tight-money periods, they have been allowed to convert a substantial part of their holdings of short-term Government debt instruments into cash and to use the resulting excess reserves to meet the pressure of the Fed while at the same time expanding their loans, albeit at a slower rate than would otherwise have been possible. In the absence of any requirement for the banks to hold a supplementary reserve against their deposit liabilities in the form of Government debt obligations, the banks have been able to sell their Treasury bills to nonbank investors and to refuse the refunding operations of the Treasury for maturing issues. Commercial banks have thus been able to increase the income velocity of money by activating idle balances within the banking system; that is, though the internal transfer of demand deposits does not affect the total money supply, its rate of utilization is affected. Required reserves, in the final equilibrium position, are unaltered and the velocity increase represents a conversion, on the asset side, from investments to loans. By way of contrast, CD's permit the expansion of bank loans via a drop in required reserves. And with the overly permissive cooperation of the Federal Reserve System in changing regulation Q to suit the needs of the commercial banking system, the banks have been able to bid aggressively for CD's and control the amounts issued by paying the appropriate interest rates.

For purposes of illustrating the effects of CD's, I will assume the following: (1) That all banks are totally loaned up and will continue to be so; (2) that the public's subjective preferences are such that CD's and demand deposits are considered to be very close substitutes; (3) that interest rates on time deposits are not at the maximum ceilings set by regulation Q; and (4) that the Treasury bill rate on new issues is at least 25 basis points below the CD rate on comparable maturities. Under these assumptions, the commercial banking system will bid for time deposits by raising the interest rates payable on such deposits. As a result funds will quickly switch from demand to time deposits within the commercial banking system. Given the lower reserve ratio required on time deposits, excess reserves will be generated by virtue of the drop in total required reserves. The banking system as a whole will therefore be able to expand loans and secondary deposits by some multiple of the newly created excess reserves. The initial drop in the money supply induced by the switch out of demand deposits will thus be partially offset. The net result will be a less than proportionate fall in demand deposits (and hence in the money supply) and an increase in income velocity through the activation of idle balances.

The very fact that we assumed zero excess reserves before the switch can be taken to indicate a tight-money situation brought about by appropriate Federal Reserve open market operations. The increase in velocity resulting from the switch can therefore be seen as a partial offset to the effectiveness of monetary policy as a contracyclical tool. Prior to the emergence of CD's, velocity increases were, as we have seen, largely the result of banks and nonbank corporations moving out of Treasury bills. CD's are merely the latest innovation in the postwar assault on monetary policy, with banks now in the "fortunate" position of being able to increase their lending capacity by simultaneously converting investments into loans (dumping Treasury bills) and by decreasing required reserves (issuing CD's)—thus speeding up even more the potential rate of change in the velocity of circulation.

In one sense, however, CD's are an improvement over Treasury bills from the banks' point of view. They allow the generation of excess reserves without reducing unduly the secondary reserves of the commercial banking system. Indeed, a senior vice president of the First National City Bank of New York was moved to observe a few months ago that "banks became financial intermediaries between corporate treasurers and those seeking credit; we funneled

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short-term funds to loans, and our loan expansion has been in large measure accommodated by CD's" (Dun's Review, Feb. 18, 1966).

I should point out that the same results would occur if, for example, funds were to shift from the passbook and time deposits of savings banks and savings and loan associations to commercial bank time deposits. This follows from the fact that such thrift institutions keep their reserve balances in the form of commercial bank demand deposits. A simple analysis of bank T-accounts would bear this out. Similarly, a switch by corporations from Treasury bills to CD's would have an identical effect if we make the more than reasonable assumption that the Treasury does not retire any debt. In all of these cases, there will be an increase in the velocity of circulation which will act as a partial offset to monetary policy.

I cannot, within the time allotted to me, get into any detailed analysis of velocity changes and their impact on the effectiveness of monetary policy. This is an area in which there has been much disagreement. I have, however, appended to this statement two studies which represent my own views on this issue. One is a reprint of an earlier article published in the Review of Economics and Statistics in 1960, and the other a typescript which brings the data up to date and challenges the view that velocity changes strengthen monetary policy by providing a safety valve against excessive and unintended monetary actions by the Federal Reserve. I would, nevertheless, like to take this opportunity to bring into question the views of the Federal Reserve Bank of New York on CD's as expressed in a speech by the president of that bank, Mr. Alfred Hayes ("Time Certificates of Deposit and Unsecured Notes: A Central Banker's Viewpoint," speech before the American Banking Association, Princeton, N.J., March 19, 1965). In his words:

"It is true, of course, that with a given total volume of reserves the banking system can extend a greater volume of credit the more heavily weighted its deposits are with time deposits, since reserve requirements against such deposits are relatively low. But, after all, the System can create as few or as many reserves as it deems appropriate to existing circumstances. And if it should conclude that bank credit is expanding too rapidly, it could cut back on the marginal availability of reserves."

In this same speech President Hayes recounted how in January 1961 a then vice president of the Federal Reserve Bank of New York first publicly suggested the use of CD's "with the knowledge and consent of the Bank." This suggestion, as is now well known, was quickly taken up by the First National City Bank of New York which, with the cooperation of a dealer in Government securities, saw to it that a secondary market for negotiable CD's was simultaneously set up. The Federal Reserve Bank of New York takes pride in having "invented" CD's, but it cannot have it both ways. It cannot claim to have sired CD's and then refuse to accept direct responsibility for the excesses of its progeny by assuring us that it will take appropriate neutralizing countermeasures in another area.

The recent changes in regulation Q are very relevant to this issue. Increasing the maximum permissible interest rates on time deposits every time the commercial banks find themselves in a liquidity squeeze is not, I submit, an appropriate way of coming to grips with the problem. In effect it provides the banks with more ammunition and requires the Fed to expand the scale of its operations continuously.

It will be recalled that in December of 1965, unregulated short-term interest rates rose in response to the Federal Reserve's move towards tighter money. At that time the average maturity of CD's stood at approximately 3.4 months with 20 percent, or $3.5 billion, of total CD's maturing in December. And since roughly 70 percent of the CD's are held by corporations for purposes of meeting quarterly tax liabilities and dividend payments, the banks were finding it exceedingly difficult to roll over their CD's, particularly in view of the rise in the Treasury bill rate on issues with a maturity of 6 months or more above the regulation Q ceilings existing at that time. The banks then took to issuing their own form of money by way of negotiable unsecured bank notes thus bypassing the restrictions of regulation Q—notes which, incidentally, are not subject to reserve requirements or interest rate ceilings. Under these conditions, the Fed's hand was forced. Having "invented" CD's and having encouraged the banks to use them, it had, in effect, been hoisted on its own petard. It had no choice but to increase for the fourth year in a row the maximum interest rates on commercial bank time deposits under regulation Q. For the Fed to argue that what it giveth with one hand it can taketh away with the other, is to make somewhat of a shambles

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of modern monetary policy as I see it. Clearly, the persistent and forced increases in regulation Q will require progressively larger and larger counteracting open market operations on the part of the Federal Reserve because of the resulting increases in the income velocity of money. Indeed, in its December 5, 1965, announcement the Fed stated flatly that the increase in time deposit rates "is intended to enable the banks to attract and retain deposits of businesses and individuals *and thus to make more effective use of savings funds already available in the economy* to finance their loan expansion" [italics supplied].

The December increase in regulation Q will, furthermore, accelerate velocity changes in view of its having increased the maximum rate to 5½ percent regardless of maturity. This will now allow the commercial banks to offer higher interest rates for lower maturities and for smaller denominations—thus increasing the heterogeneity of time deposits and CD's in such a way as to accommodate all of the public's possible preferences. At this writing, the Franklin National Bank in New York has already increased its rate on time deposits to the maximum, reduced the maturity to 30 days, and the denomination to $2,500. Preliminary estimates indicate that for the month of April alone over $1 billion were switched out of saving and time deposits in thrift institutions to time deposits in commercial banks. The recent change in regulation Q will now enable the commercial banks to compete for the relatively stable passbook savings in thrift institutions. It will also induce corporations, via high-interest, low-maturity CD's, to reduce their idle balances to an absolute minimum. In addition the very high alternative cost of holding demand deposits will induce a significant amount of economizing in transactions and precautionary balances. The net result of all this will be to augment the degree of velocity change and require still larger open market operations. I think it not inappropriate to ask, at this time, if the tail is not in fact wagging the dog; if, in other words, the Fed has not lost the initiative in determining the degree and extent of monetary policy as a contracyclical weapon.

The Fed's sanguine approach to the problem of CD's can be challenged on other grounds as well. It was the Federal Reserve Bank of New York, under the leadership of Allan Sproul and Robert V. Roosa, which in the 1950's did so much to champion the cause of a "new" monetary policy and theory. This new approach was based on the large public debt accumulated during World War II. It was argued that this debt was held by large, yield-conscious, conservative, nonbank financial intermediaries which could easily be locked-in to the public debt by very small changes in interest rates via the open market operations of the Federal Reserve System. The apparent beauty of this new approach to monetary policy was that it extended the Federal Reserve's control to all financial intermediaries without requiring any statutory extension of its powers. By shifting the emphasis of monetary control to the supply side and the availability of credit, it was argued that monetary policy had been transformed by the public debt into a delicate and sensitive instrument capable of achieving the goals of economic policy, in conjunction with fiscal measures and with a minimum interference by the Federal government in the American economy. This new monetary approach has been with us since the accord of 1951, but interest rate changes have not been confined within the narrow range anticipated and velocity changes have been more than troublesome with no apparent maximum yet in sight.

An alternate development in postwar monetary theory was the Gurley-Shaw thesis of the growth of such nonbank financial intermediaries as savings banks, savings and loan associations, and insurance companies, to mention only the most prominent ones. It seems to me ironic that in empirical fact postwar velocity changes are more to be explained by the actions of commercial banks and corporations than by the potential, though never realized, threat of nonbank intermediaries to undermine monetary control by overly extending the supply of credit. The crowning irony, however, is that with the consecutive changes in regulation Q in each of the years from 1962 to 1965, the commercial banks have been practically converted into their own nonbank intermediaries.

The ultimate responsibility for this state of affairs rests squarely with the Federal Reserve System. Having fathered both the new monetary theory and the newest of all the short-term money market instruments, it is now in the position of having undone its case for a sensitive, refined, and improved technique of monetary control operating within a narrowly prescribed range of interest rate variation.

I do not, of course, attribute this state of affairs exclusively to the emergence of negotiable certificates of deposit. But there can be no doubt, in my mind at least, that CD's have been a contributing factor in recent years, and I would expect them to increase in importance over time. One possible course of action

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would be to make all CD's nonnegotiable, or as a compromise negotiable only in very large denominations. Specifically, with regard to the various bills currently before this committee, my own preference would be for section 1 of Mr. Rees' bill, H.R. 15173, which would prohibit insured banks from issuing negotiable CD's and unsecured notes. I find, however, that I do not understand the reasoning behind section 2 of H.R. 15173 since I do feel that some spread in interest rates is justified between passbook savings and nonnegotiable time deposits.

Apparently most of the bills now before this committee are concerned with the impact of CD's on thrift institutions. My own concern, however, is with the monetary policy implications of negotiable CD's and high-cost time deposits. From this point of view I would favor abolishing the distinction between city and country banks and requiring a uniform legal reserve ratio for all demand and time deposits. This would strengthen monetary policy by severely limiting the power of the banks to generate excess reserves through a reduction of their total required reserves. It would also serve to lessen the pressure on thrift institutions for commercial banks would not be willing to encourage the inflow of high-cost money if their excess reserves were not affected. Perhaps this approach is to be preferred even to section 1 of H.R. 15173. It would achieve the same ends while at the same time contributing to the effectiveness of monetary policy. As for velocity changes attributable to the dumping of Treasury bills by the banks, a standby supplementary reserve requirement administered by the Federal Reserve System would also be in order.

I would, however, regard the committee bills and my own proposals as a patchwork approach to a serious problem. I think it is time we took a good look at commercial banks and their relation to the Federal Reserve System. We might also consider at the same time how we might improve upon the Federal Reserve System so as to increase its power and authority to regulate the flow of credit and decrease the influence of the commercial banking system on its actions.

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APPENDIX A

[From the Review of Economics and Statistics, vol. XLII, No. 1, February 1960, pp. 27-36]

VELOCITY CHANGES AND THE EFFECTIVENESS OF MONETARY POLICY, 1951-57

Stephen W. Rousseas

THIS paper will analyze changes in income velocity from 1951 through 1957. Velocity changes are, of course, the composite of the various leakages to monetary policy, perhaps best interpreted, in Keynesian terms, as a shift of money from inactive to active balances (dishoarding). Indeed, it could be argued that the large increases in interest rates during the tight money policy of 1955-57 served as the incentive to bring into play alternate sources of credit — sources which were not directly subject to control by the Federal Reserve. The attempt to cut off the peak via general monetary controls did not prove effective. Under the circumstances, a re-evaluation of indirect controls may be in order.

The usual arguments in support of general monetary controls turn on the supposed impersonality of such controls and their compatibility with the principles of democracy and free enterprise. General monetary controls may be defined as those which affect the environment within which individual decisions are made without consciously singling out any particular individual; the impact on individuals depending on the states of individual asset preferences or the changes induced in such preferences by changes in the intensity of general controls. The definition, of course, does not exclude the likely probability that the impact of a change in general controls will be unequal in its effects on different individuals, particularly when differences in individual market power exist. That is, as long as either (i) market power is unequally distributed, or (ii) asset preferences differ, general controls will be selective in their impact. It can be argued, further, that the patterns of asset preferences are not independent of the power constellations in the economy. And if the effects of general controls are not randomly distributed, they must follow the existing channels of power, with the consequence that the power differences are further reinforced. There is no such thing as a "neutral" monetary policy.

An additional point concerns the dilemma of the general controls approach. Monetary policy, by design, does not intervene selectively in particular markets or sectors of the economy. The Central Bank does not have the power, in other words, to encourage expansion in depressed sectors and restrain other sectors or markets where expansion would result in economic disharmonies.[1] If an excessive rate of growth in one or more sectors of the economy introduces distortions which threaten the stability of the whole, indirect controls, in their general approach, are faced with a dilemma. Either they permit the disequilibrating expansion to continue, or general restraints are introduced which affect other sectors of the economy as well. If these other sectors were initially in a depressed condition, their situation worsens. If, on the other hand, they were expanding at a reasonable rate, they should have been left alone. In either case the results are not conducive to stability. And if general controls have only a minimal effect on the unduly expanding sectors because of their over-riding profit expectations, the net result is worse than if nothing at all had been done. It may be that if monetary policy is to be made an effective instrument for economic stability and growth, direct and purposefully selective financial controls are needed. This, however, is beyond the immediate scope of this paper.

I

Let us turn to a consideration of changes in the income velocity of money. For any change in velocity, with the money supply constant, there exists some equivalent increase in M with V constant. One represents a relative increase in the supply of money, the other an absolute increase. The equivalence of ΔV and ΔM is, of course, in terms of a given increase in the

[1] Cf. James W. Angell, "The Monetary Standard: Objectives and Limitations," *American Economic Association, Papers and Proceedings, American Economic Review*, XLVIII (May 1958), 76-87. I might add that I am much indebted to Professor Angell for his comments and for his encouragement.

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GNP, i.e., the increase in money GNP is financed by an increase in the relative or absolute supply of money. Yet the effects of these two alternate methods are not equivalent. A constant absolute money supply with an increase in the demand for the use of these funds may result, within a given financial framework, in a movement along a corresponding interest-velocity curve, which may subsequently be followed by the shifting of the curve via accelerated institutional changes.[2] The changes induced by relative increases in the money supply are largely irreversible; they represent permanent leakages to monetary policy with which we then have to live. It is, in other words, the restriction of the absolute money supply, either by holding it constant or by reducing it, which increases the relative supply through the changes in velocity (dishoarding). However, for any increase in velocity, whether a movement along or a shift of the velocity curve, there exists some decrease in the availability of credit (increase in the rate of interest) which would just offset the velocity change.

Along these lines, one usually hears the argument that perhaps monetary policy was not used as much as it should have been; that *theoretically* there exists *some* rate of interest (or some reduction in the absolute money supply) at which velocity shifts or changes would be offset and the goals of monetary policy achieved. But here it becomes relevant to ask if this "effective" rate of interest lies within the institutional range of interest rates. I would argue that there is a ceiling to the rate of interest as well as a floor, and the problem is whether the "effective" rate of interest, or, equivalently, the "effective" reduction in the availability of credit, is within the institutionally feasible range. It is also relevant to consider how close we are to either limit in relation to the desired direction of movement.

My argument for an interest rate ceiling pivots around the phenomenal growth in the public debt and consumer installment credit. Beyond a certain range the distributional impact of large changes in the rates of interest becomes politically unfeasible, particularly with respect to installment credit where the *de facto* rate of interest is roughly twice the nominal rate. There is also the curious fact that, unlike commodity and factor prices, interest charges are still subject to medieval notions of just price and usury.

II

Clearly, these arguments do not agree with those of Sproul and Roosa.[3] The "new" monetary policy emphasizes the greater sensitivity of conservative financial institutions to small changes in interest rates. That is, given the size of the federal debt and its wide distribution among yield-conscious institutions, it now takes less to do more. The geometry of social existence, so to speak, is taken to have changed in favor of monetary policy.

The argument of increased sensitivity also emphasizes the impact of small changes in interest rates on the expectations of investors. For example, Roosa writes that "the desired degree of tightness can no doubt be obtained with a relatively small price (rate) change — so small, perhaps, as superficially to appear trivial. But the potency of such a change comes from the impact of 'uncertainty' upon markets dominated by sensitive investors . . ." (op. cit., 284). "[T]here is," he adds, "a useful contribution to be made — through creation of market uncertainty over rate movements, through a simple reversal in the direction of rate movements, and through small and successive changes in a consistent direction" (page 295).

In a similar vein, Allan Sproul writes that "the money market . . . is still sensitive (and will continue to be sensitive) to relatively small changes in the interest rate structure, and to any uncertainty concerning the future direction of rates created by such changes, in terms of its readiness to make funds available for expansion" (op. cit., 321). He continues: ". . . in this unsettled world, business men and bankers, borrowers and lenders, those who manage insurance companies and pension funds and the like, are aware of what a change in the direction of movement of interest rates may portend . . . And I believe they are sufficiently sensitive to this influence to warrant reliance upon a policy of

[2] Cf. Hyman P. Minsky, "Central Banking and Money Market Changes," *Quarterly Journal of Economics*, LXXI (May 1957), 171–81.

[3] Allan Sproul, "Changing Concepts of Central Banking," in *Money, Trade, and Economic Growth* (New York, 1951), 296–325; and Robert V. Roosa, "Interest Rates and the Central Bank," *ibid.*, 270–95.

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modest variations in interest rates . . ." (page 322).

The extreme limit to which this approach was capable of being pushed in 1950 is illustrated by Professor Musgrave.[4] "Let us suppose now," he writes, "that the government does not actually increase the supply of debt or reduce the supply of reserve money, but merely leads investors to believe that such steps will be taken. Investors, expecting a decline in bond prices to occur, will now prefer to hold money in order to avoid capital losses . . . Indeed, the creation of expectations that rates will rise by x points will do more to tighten the market than will an actual rise by x points, unless accompanied by further expectation of rise . . ." (pages 235–36).

Another aspect of the sensitivity argument concerns the impact of the federal debt on the structure of the money market. The intensive development and use of federal funds and the growth of professional dealers in government securities, along with the marked willingness of the larger corporations to invest their cash balances in Treasury Bills—all these changes have resulted in an integrated national money market with highly developed lines of communication.[5] Consequently, central bank policies have an immediate impact on a highly sensitized money market.

III

In the provocative article cited above, Professor Minsky argued that monetary policy techniques cannot be isolated from the institutional format within which they must operate. If the institutional framework is stable then increases in interest rates may well result in the activation of idle balances as a *partial* offset to a restrictive monetary policy. In Minsky's words, "if the institutional framework is stable, a tight money policy will be effective and the interest rate will rise *to whatever extent is necessary* in order to restrict the demand for financing to the essentially inelastic supply" (page 182, italics supplied). That is, given the money supply, velocity can increase only to some finite limit. At this limit monetary policy becomes effective.

Professor Minsky, however, does not consider the possibility that the interest rate rise "to whatever extent is necessary" may not be institutionally feasible in terms of an interest rate ceiling, or that by the time idle balances are exhausted within a given institutional framework the inflation may have run its course, influenced by the distributions of market power in the economy. Minsky's primary concern lies with the causal relationship between changes in interest rates and the institutional changes brought about via the operation of the profit motive. He postulates a feedback mechanism between changes in interest rates (or, more accurately, changes in the availability of credit) and the institutional framework of the financial sector. In effect, he argues that monetary restraint results in institutional innovations which represent a parametric shift in the interest-velocity relationship, and that consequently "while an institutional innovation in the money market is working its way through the economy, the net effect is as if the V-curve were infinitely elastic." As an illustration of his thesis, he describes the federal funds market and the government bond houses as "two recent institutional changes." Minsky, perhaps a bit uncritically, uses the increase in interest rates as the trigger for these institutional changes. But these changes were occurring long before monetary policy tightened in 1955–57. The rise in the federal debt is a more likely candidate for the trigger. At any rate, it would perhaps be more accurate to synthesize these two positions by arguing that rapidly rising interest rates *accelerate* (not originate) the velocity-shifting institutional changes in the financial sector of the economy.[6]

Yet I do not find any empirical support, dur-

[4] Richard A. Musgrave, "Money, Liquidity and the Valuation of Assets," in *Money, Trade, and Economic Growth* (op. cit.), 216–42.

[5] Cf. Robert V. Roosa, op. cit., and *Federal Reserve Operations in the Money and Government Securities Markets* (Federal Reserve Bank of New York, July 1956). For the argument turned against itself see Hyman Minsky, op. cit. Also, for a criticism of the "locking-in" effect, see Warren Smith, "On the Effectiveness of Monetary Policy," *American Economic Review*, XLVI (September 1956), 588–606.

[6] Minsky is not altogether clear on this point. He seems to hold both views simultaneously. "In the recent past (1954 to date) short-term interest rates in the United States have been relatively high and rising. *During this period* at least two changes in the American money market have occurred: the development and growth of the federal funds market; and the increase in the importance of nonfinancial corporations in financing government bond houses." (Pp. 172–73, italics supplied). He can indeed be challenged on "during this period."

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ing 1951–57, for Minsky's thesis that it is *during* a tight money period that shifts occur in the velocity curve. I do find, however, that a shift did occur *between* the inflationary periods, with the recession of 1953–54 acting as the break-point for the shift.

I propose now to consider the empirical data for 1951–57. Following Roosa, I shall argue that the most sensitive indicators of the state of credit availability are the federal funds rate, the dealer loan rate (on renewals and new money), and the Treasury Bill rate. The relationship between these various short-term rates and the income velocity of money will be shown. The implications for monetary policy will then be examined.

IV

Table 1 gives the seasonally adjusted quarterly data at annual rates, from the second quarter 1951 to the third quarter 1957, for the gross national product, the supply of money, and the income velocity of money. It is clear from this table that the 1951–53 period can hardly be described as one of tight money. The money supply increased from $115.7 billion in the second quarter of 1951, the date of the Federal Reserve-Treasury Accord,[7] to $126.3 billion in the third quarter of 1953. It is also clear from Table 1 that, given a relatively stable income velocity, the increase in the money supply did not find its way into hoards but went largely into financing the $37 billion increase in GNP. The data are summarized in Table 2. GNP increased by 11.2 per cent, the money supply by 9.2 per cent, and velocity by 1.9 per cent. Allowing time for the Federal Reserve to adjust to the Accord, we can take the fourth quarter of 1951 as our starting point. The absolute increases in GNP, M, and V are $29.2 billion, $6.2 billion, and .091, respectively. The percentage increases are: 8.7 for GNP, 5.3 for M, and 3.2 for V. The conclusions are not materially affected, except that, interestingly enough, V increases, compared to the broader period, when the supply of money is moderately re-

[7] Since the object of this paper is to give an evaluation of monetary policy as an anti-inflation weapon, all tables and diagrams will begin with the second quarter of 1951 when the Federal Open Market Committee was once more set free to engage in credit policy.

TABLE 1. — GROSS NATIONAL PRODUCT, SUPPLY OF MONEY,[a] AND INCOME VELOCITY OF MONEY, 1951-II THROUGH 1957-III

(*Seasonally adjusted annual rates by quarters in $ billion*)

	Year and Quarter		GNP	M	V
	1951	II	329.3	115.7	2.846
		III	330.9	118.0	2.804
		IV	337.1	120.0	2.809
	1952	I	338.4	121.4	2.787
		II	340.1	122.9	2.767
		III	345.2	123.8	2.788
		IV	358.1	124.5	2.876
	1953	I	361.6	125.2	2.888
		II	367.4	126.2	2.911
		III	366.3	126.3	2.900
Recession		IV	357.5	126.4	2.828
Recession	1954	I	358.1	126.5	2.831
Recession		II	358.7	126.8	2.829
Recession		III	360.0	128.5	2.802
Recession		IV	367.7	129.4	2.842
	1955	I	379.0	131.3	2.887
		II	387.7	132.1	2.935
		III	397.0	132.9	2.987
		IV	402.8	132.7	3.035
	1956	I	405.2	133.0	3.047
		II	410.8	134.0	3.066
		III	416.7	134.0	3.110
		IV	426.0	134.2	3.174
	1957	I	436.3	134.4	3.246
		II	441.2	134.9	3.271
		III	445.6	134.9	3.303

[a] Money supply equals checking deposits adjusted for interbank deposits plus currency outside the banks.
SOURCE: *Federal Reserve Bulletin* and *Survey of Current Business*.

strained. Our conclusion on the restrictiveness of monetary policy remains; an average annual increase of $3.2 billion in the money supply can hardly be characterized, under the circumstances, as a tight money supply.

TABLE 2. — ABSOLUTE AND RELATIVE INCREASES IN GNP, M, AND V, 1951-II THROUGH 1957-III

Period	Absolute increase: $ billion GNP	Absolute increase: $ billion M	Absolute increase: V	Per cent increase: GNP	Per cent increase: M	Per cent increase: V
1951-II to 1953-III	$37.0	$10.6	.054	11.2	9.2	1.9
1955-I to 1957-III	$66.6	$3.6	.416	17.6	2.7	14.4
1951-IV to 1953-III	$29.2	$6.2	.091	8.7	5.3	3.2
1956-II to 1957-III	$34.8	$0.9	.237	8.5	0.7	7.7

From the first quarter of 1955 to the third quarter of 1957, on the other hand, the supply of money increased by $3.6 billion (compared to $10.6 billion in the 1951–53 period) while

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the GNP rise of $66.6 billion was financed primarily by a velocity increase of 14.4 per cent. Allowing for the necessary lags in policy decisions, it can be seen that in the 1955–57 period the Federal Reserve severely restrained the money supply from the second quarter of 1956 to the third quarter of 1957. The money supply increased by the trivial amount of $900 million. Nevertheless, the income velocity of money increased by 7.7 per cent thus allowing for a $34.8 billion increase in the money GNP within a little over a year's time. It is this relationship we wish to examine.

Table 3 gives the data for various short-term interest rates. The relationship between the three-month Treasury bill rate on new issues and velocity is shown in Chart 1. The bill rate can be taken as an indicator of the state of credit availability relative to demand for the periods under consideration. The 1951–53 period appears a bit confused with the velocity curve turning in on itself. The Treasury bill rate between the second quarter of 1951 and the third quarter of 1953 ranged from a low of 1.532 to a maximum of 2.203, representing a maximum percentage increase of 43.8. In the 1955–57 period the maximum percentage increase in the bill rate was 132.3, from 1.456 to 3.382. Significantly, the maximum percentage increase in velocity was 14.4 in the 1955–57 period compared to 5.2 in the 1951–53 period. These results are given in Table 4 and shown in Chart 1.

TABLE 3.—TREASURY BILL RATE, FEDERAL FUNDS RATE, DEALER LOAN RATES, AND VELOCITY OF MONEY[a]

(Quarterly data)

	Year and Quarter		Bill Rate[b]	Federal Funds	Dealer Loan Rates		Velocity
					Renewals	New Money	
	1951	II	1.532%	0.824%	1.694%	2.083%	2.846
		III	1.628	1.518	1.839	2.234	2.804
		IV	1.649	1.171	1.883	2.250	2.809
	1952	I	1.640	0.918	1.704	2.157	2.787
		II	1.678	1.597	1.821	2.016	2.767
		III	1.829	1.513	2.032	2.127	2.788
		IV	1.924	1.668	1.996	2.111	2.876
	1953	I	2.047	1.790	2.246	2.431	2.888
		II	2.203	1.466	2.318	2.768	2.911
		III	2.022	1.554	1.981	2.750	2.900
Recession		IV	1.486	1.415	1.870	2.158	2.828
Recession	1954	I	1.084	1.108	1.797	1.986	2.831
Recession		II	0.814	0.778	1.156	1.317	2.829
Recession		III	0.870	0.929	1.188	1.305	2.802
Recession		IV	1.036	0.981	1.112	1.296	2.842
	1955	I	1.456	1.288	1.447	1.635	2.887
		II	1.514	1.443	1.715	1.875	2.935
		III	1.861	1.915	2.338	2.731	2.987
		IV	2.349	2.347	2.176	3.279	3.035
	1956	I	2.379	2.451	2.984	3.391	3.047
		II	2.597	2.652	3.065	3.438	3.066
		III	2.597	2.751	3.167	3.484	3.110
		IV	3.064	2.890	3.492	3.783	3.174
	1957	I	3.172	2.873	3.475	3.754	3.246
		II	3.157	2.993	3.527	3.922	3.271
		III	3.382	3.161	3.997	4.178	3.303

[a] The quarter Federal Funds and Dealer Loan Rates are based on the daily figures published by the *New York Times*.
[b] Three month Treasury Bill rate on new issues. *Federal Reserve Bulletin*.

CHART 1

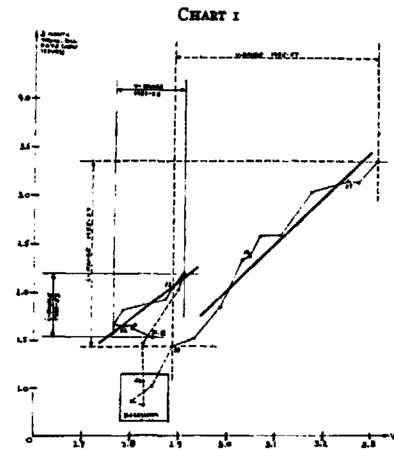

Chart 1 appears to support the shift hypothesis. The periods under consideration, however, are so short that it would seem doubtful that any radical institutional changes sufficient to explain the shift could have taken place. An explanation, however, is required.

In a sense, the quantity of money can be taken as a parameter of the velocity curve. A *severe* reduction in the supply of money may result in a shift of the V-curve. If, however, the pressures for GNP to expand are great, a policy merely to *maintain* the money supply may be sufficient to induce the shift. If the money supply, on the other hand, is expanding at the same

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TABLE 4. — SHORT-TERM INTEREST RATE AND VELOCITY RANGES, 1951-II THROUGH 1957-III

				Dealer Loan Rates		
		Bill Rate	Federal Funds Rate	Renewals	New Money	Velocity
1951–53	Max	2.203%	1.554%	2.318%	2.768%	2.911
	Min	1.532	0.824	1.694	2.083	2.767
Difference		0.671	0.730	0.624	0.685	0.144
% Change		43.8	88.5	36.8	32.9	5.2
1955–57	Max	3.382	3.161	3.997	4.178	3.303
	Min	1.456	1.288	1.447	1.635	2.887
Difference		1.926	1.873	2.550	2.543	0.416
% Change		132.3	145.3	176.2	155.5	14.4

rate as GNP, such a shift would not be experienced.

In 1951–53 the expansionary pressures were satisfied almost exclusively by the rapid increase in the absolute money supply. Thus, the range of interest rate variation was small and the inducement to dishoard idle balances or the need to economize on the use of active balances was, accordingly, negligible—as is borne out by the stability of velocity during this period.

In 1955–57, when monetary policy consisted in maintaining the money supply in the face of expansionary pressures on GNP, the V-curve shifts and stretches out with a significantly broadened velocity range in response to a bill rate increase of 132.3 per cent. The hypothesis is suggested that with the given money supply, the rapidly rising interest rates served to activate idle balances with a resulting 14.4 per cent increase in the velocity of money. The movement, *during* the 1955–57 period, however, was *along* the V-curve.

Just as a statistical demand curve does not assume constant tastes and preferences, or incomes, or prices of other goods, or the number of people in a market, so our statistical velocity curve need not assume a constant institutional framework, or money supply, or techniques of monetary control. It is, however, unlikely, given the shortness of the periods under consideration, that any great institutional innovations took place. The 1955–57 velocity curve can be explained as a movement along the curve representing a more intensive use of existing institutions, with the shift to a truly tight money policy in 1955 itself triggering the shift of the V-curve. That is, the statistical shift of the V-curve can be attributed to the recourse to monetary policy for the first time in virtually thirty years.

Alternately, the very existence of a separate V-curve for 1951–53 can be questioned. Perhaps no shift at all took place; perhaps the only "true" V-curve is the curve of 1955–57. Along these lines, the data do seem to suggest an asymptote around $V = 3.5$ — approximating the 1928–29 peak. The existence of an asymptote might be taken as a sign of encouragement, for it could then be held that patient and persistent monetary policy would ultimately have its effects.[8] The only questions here concern the time lag required for monetary policy to catch on and whether the inflation would by then have run its course. Such an argument could be advanced for the 1955–57 inflation and the recession that followed it. But, more important, a given asymptote is compatible with various institutional arrangements. An asymptote does not preclude, over the longer run, qualitative types of institutional changes. And it may be that periods of tight money serve to speed up the process and influence its direction by determining which innovations will be developed and which discarded. It is the institutional rearrangements *over time* which tend to make our monetary tools obsolete and put our ability to control inflation in constant jeopardy. This is by far a more important element in the problem than the existence of a statistical asymptote. I am not convinced that the idea of a velocity asymptote has a useful meaning. If it does exist, statistically, our problem still remains — the obsolescence of monetary controls in terms of constant institutional change.

If Chart 1 is taken to indicate that the rate of interest at which further velocity changes are no longer possible (the asymptote) is not beyond the interest rate ceiling, then given the results of the 1955–57 inflation we would have to conclude that the maximum velocity limit implies a stretch in the monetary rope sufficient to let the economy at least reach its horizon. There

[8] In a letter to the writer, Professor Albert G. Hart writes that Chart 1 suggests strongly the existence of an asymptote. He goes on to say: "Suppose it did: wouldn't you then hold monetary policy could pull the economy with a snubbing-rope that stretches but not without limit? To argue that the rope stretches doesn't prove it won't stop the steer. You have to prove it will either break or keep on stretching till he vanishes over the horizon."

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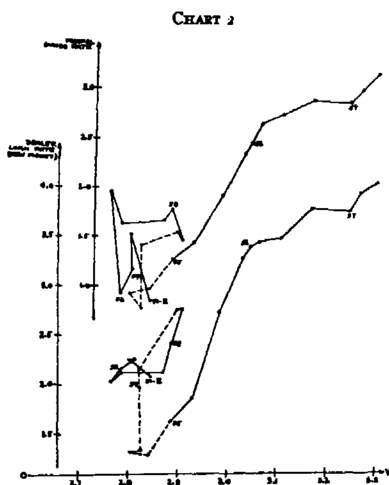
remains the possibility that had the 1955–57 inflation continued, the velocity curve would have shifted to the right. This I would doubt. For with a given supply of money, velocity curves cannot shift indefinitely. There must be some limit, and I would surmise it had been reached, but that the inflation had been free to run its course because of the obsolescence of our monetary techniques. What I maintain is that what matters is not the asymptote itself but the gradually accumulating institutional changes; for example, the evolution of nonbank financial intermediaries.

Perhaps the most important *nonfinancial* institutional change induced by general monetary controls is the additional support given to existing concentrations of economic power in the economy. General controls have a discriminatory impact against small business, while "nonmaximizing oligopolies" are largely impervious to the restrictive policies of the central bank. If monetary policy encourages concentration, then in successive inflations its ability to cope with the situation becomes progressively weakened. One writer was moved to observe that "as a centralizing influence in the economy it is possible to imagine that an active and continuing monetary policy is not less effective than, say, the repeal of the antitrust laws."[9]

The two other short-term indicators of the state of the money market are the federal funds and dealer loan rates.[10] Table 3 lists the quarterly averages for both these rates.[11] Table 4 is

CHART 2



a composite table for short-term rates, giving the range of variation for the 1951–53 and 1955–57 periods. The results, of course, parallel the Treasury bill rate. Chart 2 should be consulted.[12]

[9] J. K. Galbraith, "Market Structure and Stabilization Policy," this REVIEW, XXXIX (May 1957), 124–33. Cf. also "Member Bank Lending to Small Business, 1955–57," *Federal Reserve Bulletin*, April 1958, 393–411; "The Financing of Small Business: Survey of Second District Commercial Banks," Federal Reserve Bank of New York, *Monthly Review*, May 1958, 67–71; *Financing Small Business*, Report to Committee on Small Business by the Federal Reserve System, Parts I and II, April 11, 1958; Warren L. Smith, "Monetary Policy and the Structure of Markets," in *The Relationship of Prices to Economic Stability and Growth*, Joint Committee Print, March 31, 1958, 493–511.

[10] Cf. Robert V. Roosa, *Federal Reserve Operations in the Money and Government Securities Markets*, op. cit. "In determining the immediate state of the money market at a given hour on a given day, the interest rate to which one would have to look . . . is the 'Federal funds rate.' . . . Perhaps next in significance, as an indicator of the degree of strain or ease felt by the various leading money market banks, is the dealer loan rate . . ." (pages 30–31).

[11] I am very much indebted to three graduate students at the University of Michigan who patiently plodded through 2500 copies of the *New York Times* for these figures. Surprisingly, data on these two rates are not systematically published by the Federal Reserve. The only clues available, apart from the *New York Times*, are the Wednesday data on "borrowing from others" by weekly reporting banks to be found in the *Federal Reserve Bulletin*. Also, Wednesday data on loans to brokers and dealers for purchasing or carrying United States government obligations for New York and Chicago weekly reporting banks might be used as a measure of dealer loan transactions. The Federal Reserve Banks of New York and Chicago would have to be consulted for these figures. Wednesday data, however, are unsatisfactory since monthly averages of these data would be rather poor indicators of the actual course of events. I am indebted to Mr. Roosa for this information.

[12] The same pattern is also to be found in the data for intermediate and long-term interest rates. Though less dramatic, the movements are consistent with the data for the short-term rates. For example, the percentage changes in yields for the two periods 1951–53 and 1955–57 are: (1) from 45.8 to 77.7 per cent for 3–5 year government securities, (2) from 17.8 to 34.9 per cent for long-term government bonds, and (3) from 13.5 to 37.1 for total corporate bonds. It should be kept in mind that we are taking short-term rates as indicators of the state of credit availability relative to demand. Shorter rates are generally accepted as more adequately reflecting the degree of credit stringency. An alternative would be to define the availability of credit directly in terms of free reserves, i.e., total excess reserves less bank borrowings. By inverting the plus and minus figures for excess reserves on the *Y*-axis and plotting them against

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V

The technical arguments given in the renewed support of monetary policy emphasize, as we have seen, the structural changes that have taken place in the financial sector of the economy during and since the war. Briefly, the three major components of the theory are (i) the shift in emphasis from the rate of interest to the availability of credit, i.e., from the demand to the supply side of the money market, (ii) the increased sensitivity of the financial community to the pressures of the central bank, and (iii) the willful creation and manipulation of uncertainty in the money market by the monetary authorities.

The primary emphasis of the "new" theory, however, is on the increased sensitivity of the money market to *small* changes in the rate of interest and, secondarily, on the consequent uncertainties generated by such nominal actions. This implies that Federal Open Market Committee operations over the entire maturity range of government securities will, under the changed circumstances, be able to realize desired policy objectives without undue increases in the rates of interest.[13]

One of the objections to monetary policy in the prewar years had been the necessity of drastic measures to contain inflations and the ever-present danger of inadvertently bringing on a depression. This no longer appeared to be a problem, happily at a time when the use of deflation as a corrective device was no longer politically acceptable. With highly conservative holders of the public debt, credit policy objectives were thought to be realizable with a minimum of effort through selective and moderate central bank operation in the government securities market. But the theory has not held in practice. Virtually all holders of government securities moved out of them with impunity when conditions made it profitable to do so; and it didn't take much to make conditions profitable.[14] Matters are complicated further if "the supply of finance from cash balances in time of boom is considerably more interest elastic even to would-be spenders as a whole than the demand for funds for investment."[15] Our data on velocity tend to support this argument.

Table 4 shows that the magnitude of interest rate changes has been anything but small. In the 1955–57 inflation the Treasury bill rate increased by 132.3 per cent, the federal funds rate by 145.3 per cent, and the dealer loan rates by 176.2 and 155.5 per cent for renewals and for new money, respectively. The net effect was an increase in the velocity of money by 14.4 per cent.

The money supply in the first quarter of 1955 stood at $131.3 billion. By the third quarter of 1957 it had increased absolutely to $134.9 billion, or by the moderate amount of $3.6 billion. Yet an increase in velocity of 14.4 per cent is equivalent to an absolute increase of $18.9 billion. In effect, the money supply increased by $22.5 billion in the 1955–57 period.[16]

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velocity, the pattern of the short-term rate diagrams would be reproduced.

[13] In passing, it is interesting to observe that if the "new" monetary policy can be said to have been born in 1950 in the Federal Reserve Bank of New York, it can also be said, in an important respect, that it died in 1953 when the Board of Governors in Washington implemented the recommendations of the Ad Hoc Subcommittee on the Government Securities Market. The "bills only" policy denies to the Federal Open Market Committee the right to intervene in any sector of the government securities market other than the short end. In the name of "depth, breadth, and resiliency" the creation of uncertainties are to be minimized and the pattern of interest rates left to the dictates of a "free" market. What is left of the "new" monetary policy is a weakened version, shorn of its power to operate in the intermediate and longer maturity spectrum, in the belief that operations in the short-end are quickly transmitted along the whole range of maturities. Cf. *United States Monetary Policy: Recent Thinking and Experience*, Hearings before the Subcommittee on Economic Stabilization of the Joint Committee on the Economic Report, Joint Committee Print, December 6 and 7, 1954. See especially pages 257–330 for the Ad Hoc Subcommittee Report and the comments and views of the Federal Reserve Bank of New York. See also remarks above concerning the use of uncertainty as a tool of monetary policy.

[14] Cf. Warren Smith, op. cit., on the failure of the "locking-in" effect. "[I]n many cases a small rise in the differential between interest rates on private securities and on government securities should be sufficient to compensate the holder for capital loss incurred in the sale of government securities" (page 591). Assuming a rise in the yield of government securities from 2.5 to 3.0 per cent, Professor Smith concludes that an interest rate of 3.265 in the private sector would be sufficient to cover the capital losses to be incurred by moving out of a 10 year government bond. This would include an estimated 0.25 per cent differential between government and corporate securities because of the default risk in the private sector. For a 20 year bond, the just-compensating interest rate would be 3.178; for consols, 3.3.

[15] H. B. Rose, "Monetary Policy and the Capital Market, 1955–56," *Economic Journal*, LXVII (September 1957), 397–414.

[16] By way of comparison, the money supply in the second

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Whether we look at the problem as the response of idle balances to large and rapid increases in short-term interest rates or as large increases in the relative supply of money, it seems reasonable to conclude that a tight money policy increases the willingness of individuals and institutions to dishoard their cash balances. Under the circumstances it is not unreasonable to question, once again, the ability of monetary policy to contain inflations within tolerable limits. We seem reduced, again, to the necessity of drastic measures to make monetary policy effective, with the acute danger of inducing a deflation.[17] The circle seems to have been completed.[18] We are faced once more with the necessity of large movements in the rates of interest, larger than the ones already experienced in the 1955-57 inflation, with the result that monetary policy is no longer a delicate instrument operating on a sensitive money market, but a bludgeon landing heavily on the whole economy.

If we are to avoid the necessity of resorting to massive monetary operations, and all they imply, then the realities of our financial structure must be faced. Monetary policy can indeed be made into an effective instrument for economic stability and growth, but this would entail counteracting the velocity leakages through direct and selective controls over the financial community and the disposition of idle funds generally. Much can be said, along these lines, in favor of establishing a National Economic Council within which the reorganized Federal Reserve would be subsumed along with the Treasury and those federal agencies extending credit to housing, business, and agriculture. This, however, would take us far afield.

VI

More immediate is the necessity for understanding the causes of failure. It is unrewarding to work with changes in velocity, for once the analysis is finished, the work begins. It becomes important to interpret the changes in velocity and give them content. Changes in velocity can occur for many reasons. The unloading of government securities by commercial banks and other financial institutions, as well as by households and corporations, and the use of the proceeds of such sales for current expenditures can entail an increase in velocity if the government securities are bought by nonbank investors using what otherwise would have been idle funds. Similarly, the extension of trade credit between firms, the increase in assets receivable financing through the medium of finance companies, the use of internal funds for financing corporate investment, the stimulation which capital markets receive by the tightening of credit, the ability of nonmaximizing oligopolies to absorb interest rate charges by increasing prices and their ability to finance investment out of the increased revenues attendant to such price increases in the face of inelastic demand schedules — all these, too, result in possible velocity changes which require detailed study and documentation. There is much we do not know about the structural changes which have taken place over the past forty years in the financial sector of the economy. Our knowledge of monetary structure is primitive compared to what we know about other sectors of the economy.

We might end on this note: Economic theory is always in a state of becoming obsolete. No matter how abstract it may seem at times, it is intimately connected with the institutional arrangements and problems extant at the time of

quarter of 1951 was $115.7 billion. The absolute money supply increased to $126.3 billion in the third quarter of 1953, or by $10.6 billion. The income velocity of money increased by 1.9 per cent. Therefore, the monetary equivalent of the change in velocity was (115.7 x .019) or $2.2 billion. The total increase in the money supply, absolute plus relative, was $12.8 billion.

[17] I would not attribute the deflation of 1957-58 to an excessive monetary policy. On the contrary, monetary policy was not carried far enough, which may explain the consequent recession. It is doubtful, moreover, that much more could have been done with monetary policy if we were already operating at the interest rate ceiling. Had it been pressed further, the selective impact against the relatively competitive sector of the economy would have been greater, and along with the distribution effects through the government debt and the amount of outstanding installment debt, the political response would have been quite positive.

[18] Cf. H. B. Rose, op. cit., 414. "To cut off the supply of funds from idle balances in conditions in which a rise in interest rates would otherwise have the effect of making their owners more ready to part with them, but no appreciable effect on investment, requires either open market operations designed to mop up cash balances on a grand scale or a policy that so succeeds in influencing expectations that the fear of yet higher rates of interest induces investors to hold on to their idle balances. In practice, there may be no clear distinction between these alternatives . . ."

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its conception. In periods of rapid change, the lag with which theory reacts to institutional rearrangements and the changed problems and values adds to the sense of crisis. The progressive obsolescence of economic theory is, in other words, a function of its lagged willingness to recognize, let alone to take into account, these structural changes. And when we recognize that it is from theory that we derive our economic tools and our policy prescriptions, the problem is seen in its full perspective. New problems arise, requiring, in the changed circumstances, new theories for their solution.

The "new" monetary policy was a gallant attempt in this direction. The shift of emphasis from demand to the supply side of credit availability has much to recommend it. What remains is to incorporate within the theory the velocity changes which tend to weaken monetary policy. A re-examination of monetary techniques and central bank structure has become critical. It would help if the widespread attitude against selective financial controls was recognized for the prejudice it is. It never helps economic analysis to deal in terms of the untenable dualism of freedom versus control. Indeed, control in many instances is a precondition for the realization of freedom in the larger sense.

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[From the Review of Economics and Statistics, vol. XLII, No. 4, November 1960, pp. 455–457]

REJOINDER

Stephen W. Rousseas

Mr. Bernstein challenges my article on two counts: (1) that the subsequent events of 1957–59 modify my conclusions concerning the ineffectiveness of monetary policy, and highlight a development which may go a long way in making it effective; (2) that my analysis of the 1951–53 data lacks a balanced historical perspective.

I

On the first count Mr. Bernstein describes my position as follows: "Idle funds are sucked into activity by higher interest rates — but, *more than that*, between one inflationary period and the next, institutional changes will *shift* the income velocity/interest curve to the right." (Italics supplied). The title of my article, however, was carefully stated in terms of velocity *changes*, not shifts, and on pages 32–33 I emphasized (1) that it was unlikely, given the shortness of the periods under consideration, that any great institutional innovations took place, (2) that the very existence of a separate V-curve for 1951–53 could be seriously questioned, and (3) that the changes in V were more probably the result of an intensive use of existing financial institutions, that is, of a movement along the V-curve in the short-run.

By adding the 1957–59 data to mine Mr. Bernstein now finds evidence not only of a shift in the V-curve but, more significantly, a shift of smaller magnitude than the initial 1955–57 "shift" both absolutely and relative to the Treasury bill rate. To this he attaches a great deal of importance. Regardless of whether one interprets his data as a true shift or merely as an extension of the 1955–57 curve (and much could be said in favor of this latter interpretation), it all amounts to the same thing; namely, the existence of an upper limit to velocity changes in the short run. This is precisely the meaning which must be given to his finding that the expansion of V has become increasingly sluggish with respect to the Treasury bill rate; that a given ΔV now requires a larger Δi. Put more simply, Mr. Bernstein finds that the slope of the V-curve increases with each so-called shift — which, of course, implies, along with the decrease in absolute shift, the existence of a velocity maximum. I do not find this at all surprising. In my article I freely admitted and discussed the idea of a velocity maximum. I also anticipated Mr. Bernstein's argument by stating that "the existence of an asymptote might be taken as a sign of encouragement, for it could then be held that patient and persistent monetary policy would ultimately have its effect." Mr. Bernstein's variation on this theme is: ". . . the *increasingly* sluggish response of velocity to higher interest rates does show that holders of idle cash have insisted upon ever larger *increases* in interest rates before being willing to lend out another idle dollar. In this latter sense, monetary policy has become *more* effective." (First and last italics supplied).

The parable of the horse and the barn door is not out of place here, and it still remains for Mr. Bernstein, and those who share this view, to show that the V-changes in the short run will always exhaust themselves before too much damage is done, and quickly enough for monetary policy to do its work. This certainly has not been the case to date, unless one adopts as a definition of "effec-

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tiveness" the uninteresting truism that what is, is, and could have been worse.

There is, first of all, no particular reason to think that *spontaneous* changes in V will always prove to be minimal, or that they will always be pressing against the maximum limit. The speed and intensity of changes in V depend upon many factors: the pressures applied by the central bank, the abilities and inclinations of nonbank financial intermediaries, the sector origins of the inflationary pressures and their idle balance positions (e.g., the level of undistributed profits, say, in manufacturing industries), the state of expectations with regard to profits and the performance of the economy in general, not to mention the fiscal and debt management policies of the federal government, the character of the preceding recession, and so on. And for the longer run, qualitative institutional changes become relevant, though I leave the specific arguments on this issue, and the implications such changes have for the V-asymptote, in the context of my article.

On the basis of all this it would seem reasonable to conclude that not only will changes in V be spontaneous, but that the intensity and degree of change is also likely to be varied and unpredictable, as well as oscillating over the cycle. Yet Mr. Bernstein, on the basis of a doubtful sample of one, and by ignoring other relevant matters, has come to the dubious conclusion that the degree of change has not only diminished, but will continue to do so in the future, thus making monetary policy a progressively effective instrument of control.

The confusion in his argument can be seen in the title of his paper, "The Response of Income Velocity to Interest Rate Changes," which introduces a one-way causal arrow into his analysis. I used short-term interest rates, following Roosa and Sproul, as *indicators* of the state of credit availability (see page 32, note 10), and as a test of their main hypothesis that an effective monetary policy will result in only *small* changes in interest rates. The shift from the demand to the supply side of the money market by Roosa and Sproul implies quite openly a shift in emphasis from the rate of interest to the availability of credit as the prime mover. By undertaking open market operations *over the entire maturity range of government securities* (no "bills only" policy here), and by relying very heavily on the so-called "locking-in" effect, the central bank would be able to achieve its objectives with only nominal interest rate changes as a side effect. Mr. Bernstein apparently isn't aware of this decline in the importance of interest rates as prime movers in the Roosa-Sproul theory. In *Money, Trade and Economic Growth*, Mr. Roosa wrote:

> . . . the failings of earlier analysis and policy may be attributed to a misdirection of emphasis. Economists and central bank theorists long believed that the significance of market rates of interest, and of central banking efforts to vary these rates, lay in the effects produced upon *borrowers*, and upon *savers*. Little if any attention was given to *lenders*; their function was considered that of automatic response to central bank action, without any meaningful independent influence on economic behavior. (Pages 271–72, Roosa's italics.)

Roosa and Sproul, motivated as they were by a desire to revive monetary policy, provided a theory compatible with the existence of a very large postwar public debt; a theory which, in reply to critics, showed that monetary policy would not add significantly to the interest burden of that debt, or inadvertently bring on a depression, since certain structural changes in the economy no longer made *large* interest rate changes necessary.

The Roosa-Sproul theory notwithstanding (and the "bills only" policy is a complicating factor here), interest rates have of late been reaching new peaks. We need not, however, accept Mr. Bernstein's explanation of this phenomenon as a requirement for inducing the holders of idle cash to part with another idle dollar. The wide swings and new heights in, for example, the bill rate (which Mr. Bernstein uses) can be explained on more prosaic grounds. Corporations are increasingly holding larger amounts of their cash balances in Treasury bills. When they wish to use these balances for investment purposes or for extending trade credit to smaller businesses during tight money periods, they can either dump their holdings on the open market or refuse the refunding operations of the Treasury. In either event this will tend to drive up the bill rate significantly. Indeed, Mr. Alfred Hayes, President of the Federal Reserve Bank of New York, explains the recent wide swings in market rates of interest in these words: ". . . in the shorter term part of the market nonfinancial corporations have been a major, *and at times dominant*, factor. Thus short-run shifts in corporate cash positions that might in other countries be largely absorbed within the banking system itself are, in this country, thrown more directly upon the open market." (Federal Reserve Bank of New York, *Monthly Review*, June 1960, 103, italics supplied.)

I suspect that much of the idle cash balances activated during boom periods are not in direct response to changes in interest rates. Instead I would surmise that a not insignificant part of these balances are fairly independent of interest rate changes

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and more dependent on profit expectations, and that anyway a large part of them are held in the form of undistributed profits, over which the central bank has no control. Then again, large corporations have demonstrated a facility for financing long-term needs by temporary short-term borrowings from the banks while waiting for the capital market to shake down to more normal conditions.

Without laboring the point I must question the interpretation that Mr. Bernstein puts on the higher and higher interest rates and the conclusions he derives from them. Apart from all this I would add that the severity and duration of the intervening recessions are of critical importance here. I suspect that the nature and quality of these immediately preceding recessions, and the extent to which the central bank pursues an easy money policy, are more pertinent to the degree of velocity "shift" in the next inflation than Mr. Bernstein's thesis that his, as yet unidentified, holders of idle cash will become more resistent to lending another idle dollar. These oscillations in a postwar period of secular inflation are perhaps the most important single factor which has led to the weakening of general monetary controls. These periodic pauses plus the continuous build-up of undistributed corporate profits (which are playing an increasing role in the total investment and trade credit picture) under conditions of secular inflation, go far to replenish the liquidity pool, to a greater or lesser extent, for resisting the policies of the central bank in the next inflationary push. And it is this which makes the existence of a velocity maximum of such limited importance, apart from the longer run qualitative institutional changes, since there is no *a priori* reason to suppose that the extent of replenishment will always be of the lesser kind. Like so many other things in life, it all depends.

II

Mr. Bernstein's second criticism can be answered more briefly. It concerns my interpretation of the 1951–53 data. Above all, he questions my reluctance to describe this period as one of tight money. First, I am amazed that anyone would consider the O.P.S. experiment with direct wage and price controls as anything short of a fiasco. The Defense Production Act of 1950, though on the books as of September 8, did not institute any controls until January 1951. During this period, and in anticipation of direct controls, prices increased rapidly. And when controls finally were imposed, the peak levels were taken as the points of freeze! Both labor and management fought them and the whole system was quickly reduced to shambles. Moral suasion, which did not work and rarely does, was resorted to more than comprehensive wage and price controls. Indeed, the Defense Production Act of 1950 in its mandate to the President emphasized that the "voluntary method" be given fair trial before the imposition of any direct controls. In any event, by 1952 the controls, such as they were, were allowed to die quietly. I cannot seriously accept this part of Mr. Bernstein's argument.

As for the free reserves in the two inflationary periods I considered, is Mr. Bernstein prepared to conclude that since the average level of negative free reserves in 1952–53 was larger than that of 1955–57, that therefore money was tighter in 1951–53 than it was in 1955–57? The disparity was not that great, and I bring the following additional information to his attention. Out of the ten quarters of the 1951–53 inflation, free reserves were negative in four; of the eleven quarters in the 1955–57 inflation, free reserves were negative in nine. More importantly, the money supply increased by $10.6 billion in the first inflation and by only $3.6 billion in the second. For these and other reasons I therefore continue to maintain that though the central bank did move somewhat belatedly in the direction of tighter money in the 1951–53 period it did so with a great deal of understandable timidity and can hardly be accused of having overdone things.

Furthermore, bank credit is beginning to play a decreasing role in financing inflations. This is precisely the crux of the matter and the very thing which underlies the velocity changes which represent this fact. I refer Mr. Bernstein to the liquidity thesis of the Radcliffe Report which is no more than the other side of the *V*-coin — though the Radcliffe Committee has shown a rather touching faith in the efficacy of the "locking-in" effect.

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APPENDIX B

Growth, Economic Stability, and Short-Run Changes in the Income Velocity of Money *

(By Stephen W. Rousseas, New York University)

I

Changes in income velocity are, admittedly, changes in an arithmetic average. As such, they carry no meaning beyond that which is attributed to them by differing interpretations. The liquidity thesis of the Radcliffe Report is one particular interpretation which has a remarkably close, though unacknowledged, resemblance to the Gurley-Shaw theory of financial intermediaries.[1] Another interpretation is that of Warren Smith[2] and his disagreement with Gurley-Shaw. Still another is the "shift-hypothesis" of Hyman Minsky.[3] There are others. My sole interest in this paper, however, will be with the *safety-valve-plus-growth* interpretation of velocity changes.[4] This interpretation is of particular interest because it overrides disagreements concerning the empirical meaning to be given to changes in velocity. For velocity changes do occur and, regardless of the exact institutional mechanics of such changes, we are told that they have served, in the postwar period, a very useful though so far unintended purpose.

Short-run velocity changes are seen as having resolved a fundamental monetary dilemma. A central bank, for example, should be concerned with two simultaneous policy objectives: the maintenance of short-run economic stability, and provision of the monetary means for economic growth. In periods of short-run expansionary pressures, the central bank should restrain the money supply, but for growth purposes the money supply should be permitted to increase. If the central bank should decide to cut the money supply in what it takes to be a developing inflationary situation, it may at the same time jeopardize the real growth of the economy. It is precisely here that the "advantages" of velocity changes are supposed to enter. These so-called advantages operate on two levels and thus resolve the dilemma initially posed.

With respect to short-run economic stability, velocity changes are said to endow the central bank with a greater flexibility. They do so by providing it with "the needed safety valve, tempering and graduating the impact of monetary policy and thereby enabling the central bank to apply more restraint than it might otherwise risk"[5] much as the discount window partially absorbs and softens the impact of a Federal Open Market Committee operation which, alone, would have proved *ex post* to be excessive. The main point of the argument, however, is that velocity changes are the key to resolving the potential conflict in monetary policy between short-run economic stability and the real growth of the economy. A schematic presentation of this thesis follows.

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*I am indebted to my colleagues Peter Albin, G. K. Shaw, and Bruno Stein for their critical comments and to Mr. C. K. Leung for his assistance in gathering the necessary data.

[1] *Cf., Committee on the Working of the Monetary System: Report,* (H.M.S.O., August 1959), p. 133.

[2] "Financial Intermediaries and Monetary Controls," *Quarterly Journal of Economics,* November 1959, pp. 533–553.

[3] "Central Banking and Money Market Changes," *Quarterly Journal of Economics,* May 1957, pp. 171–181.

[4] Lawrence R. Ritter, "Income Velocity and Monetary Policy," *American Economic Review,* March 1959, pp. 120–129.

[5] *Ibid.*, p. 127.

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II

For any given increase in the money GNP we can write

(1) $$\Delta Y = Y_1 - Y_0 = M_1V_1 - M_0V_0$$

which can be rewritten as [6]

(2) $$\Delta Y = \Delta M(V_1) + \Delta V(M_0)$$

Equation (2) can be restated in a different form by introducing the definition of an increase in the *indirect* money supply, i.e.,

(3) $$\Delta M_i = M_0(\Delta V/V_0)$$

ΔM_i is simply the monetary equivalent of a change in income velocity which is computed by multiplying the base-date *direct*, or conventionally defined, money supply by the percentage change in velocity. Barring decreases in velocity during an expansionary period, the minimum value of ΔM_i is zero; the maximum value, however, is determined by the maximum short-run value of V with a fixed money supply and within a given institutional framework.

Multiplying both sides of equation (3) by V_0 we get

(4) $$\Delta M_iV_0 = [M_0(\Delta V/V_0)]V_0$$
$$= \Delta VM_0$$

Using the concept of indirect money, equation (2) can now be rewritten as

(5) $$\Delta Y = \Delta M_d(V_1) + \Delta M_i(V_0)$$

where ΔM_d = the increase in the direct money supply.

Equation (5) and the safety-valve-plus-growth hypothesis can be made clearer by considering the two limiting cases to which this equation can be reduced. If $\Delta V = 0$, then from equation (3) ΔM_i must also be zero, and from equation (5) we get

(6) $$\Delta Y = \Delta M_d(V_0)$$

since, by assumption, V_1 must now equal V_0.

If, on the other hand, $\Delta M_d = 0$, then

(7) $$\Delta Y = \Delta M_i(V_0)$$

From these last two equations it follows that ΔM_dV_o and ΔM_iV_o are two *logically* equivalent ways of accounting for the same thing, i.e., for a *given* increase in the money GNP. But more than this, the implication is that reliance exclusively on $\Delta M_d(V_o)$ or on $\Delta M_i(V_o)$ will result in different ΔYs, and that these ΔYs compared to their attendant real rates of growth will entail different consequences for the economy.[7] All this amounts to the following. The state of affairs represented by equation (6) should, as a matter of choice, be employed less frequently since the effect of increasing the money supply is to decrease the

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[6] The derivation is simple enough:

$$M_1V_1 - M_0V_0 = (M_0 + \Delta M)(V_0 + \Delta V) - M_0V_0$$
$$= \Delta M(V_0 + \Delta V) + \Delta VM_0$$
$$= \Delta M(V_1) + \Delta V(M_0)$$

[7] Of course, any *given* ΔY realized by one path could also be achieved via the other. Knowing one, the other could be computed. The important distinction, however, continues to be that the two policy paths will entail different growth rates in the real and money GNPs. In short, the social and economic consequences of these two approaches will not be the same—which is the crux of the safety-valve hypothesis. Much will be made of this distinction in the empirical applications of a growth version of equation (5).

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degree of monetary restraint. The case represented by equation (7) is regarded as more desirable in fighting inflation in that it would maintain a tighter control over the situation while providing the monetary means for real growth via increases in the *indirect* money supply. Central banking, however, is still an art; it is not that fine a tool. When the short-run velocity maximum is reached (assuming that such a maximum exists), the constant money supply implied by equation (7) might well endanger the stability of the economy and induce a decline in the level of economic activity and hence in the real rate of growth. Equation (5), representing some combination of these two extremes, is therefore to be preferred, though with the following proviso: *that the central bank provide the monetary means for economic growth by relying primarily, though not exclusively, on spontaneous changes in the income velocity of money.* Equation (5) is therefore to be interpreted as a closer approximation to equation (7) than to equation (6), i.e., the central bank should as a matter of policy rely more on increases in the indirect than in the direct money supply. Just how the central bank is to determine the *optimum* mix, let alone achieve it, is of course an unresolved mystery. This is an expecially acute problem if the velocity changes the central bank is to rely on are spontaneous in nature and without an apparent maximum. We shall return to this issue in a later section of this paper.

III

Equation (5) can be restated more usefully in growth terms. Dividing the left-hand side by Y_0 and the right-hand side by its monetary equivalent, M_0V_0, we get

$$\frac{\Delta Y}{Y_0}=\frac{\Delta M_1(V_1)}{M_0V_0}+\frac{\Delta M_i(V_0)}{M_0V_0} \tag{8}$$

Since $\Delta M_i/M_0=\Delta V/V_0$, we can rewrite equation (8) as

$$G_y=G_m(1+G_v)+G_v \tag{9}$$

where G represents the various growth rates.

Therefore, equation (8) becomes

$$G_y=G_m+G_v+G_mG_v \tag{10}$$

From the goods-side of the quantity equation, we get

$$\frac{\Delta Y}{Y_0}=\frac{(P_0+\Delta P)(Q_0+\Delta Q)}{P_0Q_0}-1 \tag{11}$$

$$=1+\frac{\Delta P(Q_0)}{P_0Q_0}+\frac{P_0\Delta Q}{P_0Q_0}+\frac{\Delta P\Delta Q}{P_0Q_0}-1$$

Therefore,

$$G_y=G_p+G_q+G_pG_q \tag{12}$$

Ignoring the cross products of equations (10) and (12), which would be very small within their relevant ranges, and dividing through by G_y, we get

$$1=\frac{G_m}{G_y}+\frac{G_v}{G_y}=\frac{G_p}{G_y}+\frac{G_q}{G_y} \tag{13}$$

Equation (13) measures the relative contribution to a change in income made by the money supply, the income velocity of money, the price level, and real income.

All other things equal, the safety-valve-plus-growth hypothesis introduces a causal relationship into the above tautologies by implying that a primary reliance on G_m/G_y should lead to a larger G_p/G_y and a smaller G_q/G_y. Conversely, a heavy reliance on G_v/G_y should result in a smaller G_p/G_y and a larger G_q/G_y. We are now in a position to test this hypothesis *on its own terms* by introducing the actual data of the four major expansions since the Federal Reserve-Treasury Accord of March 1951.

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IV

There are several reasons for limiting the analysis to the post-Accord period. In a very real sense, modern monetary policy with its primary emphasis on active open market operations as an anti-inflationary policy tool dates from this period. It also has the added advantage of coinciding with the emergency of the "availability of credit" doctrine. And, finally, it covers a span of time which excludes the special excess demand cases of the immediate postwar expansion of 1946–48 and the sharp price rises induced by the outbreak of the Korean War in June of 1950. That is, the underlying economic forces for the periods covered are relatively homogeneous and, with the exception of the first post-Accord period, share among themselves the generally chronic problem of underemployment with the economy running below its full employment potential. Also, in a very rough way, the first expansion and the latter part of the most recent upswing reflect, though to a different degree, the influences of the Korean and Vietnam Wars, respectively.

Specifically, the four post-Accord expansions to be covered are: (1) 1951–I to 1953–II, (2) 1954–II to 1957–III, (3) 1958–I to 1960–II, and (4) 1961–I to 1965–III. Only the second and third expansions cover the complete range from trough to peak. The first expansion begins, as noted, with the 1951 Accord and the last expansion starts with the trough of 1961–I and proceeds to the last current quarter for which data are available. The data covering these four periods are provided in Appendix I. Based on this Appendix, Table I summarizes the various growth rates of equations (10) and (12) and lists the relative contributions of equation (13) in parentheses.

TABLE I.—*Postaccord expansions*

Period	Number of quarters	Average unemployment rates	Average budgetary surplus (+) or deficit (−) (billions)	G_y	G_m	G_v	G_p	G_q
1951-II to 1953-II	8	3.0	−3.0	6.0	4.4 (73.3)	1.6 (26.7)	1.6 (26.7)	4.4 (73.3)
1954-II to 1957-III	13	4.6	+0.9	6.6	1.8 (27.3)	4.8 (72.7)	2.8 (42.4)	3.8 (57.6)
1958-I to 1960-II	9	6.0	−4.5	6.8	1.5 (22.1)	5.3 (77.9)	1.6 (23.5)	5.2 (76.5)
1961-I to 1965-III [1]	18	5.8	−0.4	6.6	3.4 (51.5)	3.2 (48.5)	1.4 (21.2)	5.2 (78.8)

[1] Not a peak quarter; latest data available.

Source: App. I, CEA Annual Reports, and Survey of Current Business, August 1965.

From Table I it can be seen that the money GNP growth rates for all four expansions are roughly comparable. The money supply growth rates, however, indicate two periods of relative monetary ease (1951–53 and 1961–65) and two of tightness (1954–57 and 1958–60). We are, therefore, in a position to test the safety-valve-plus-growth hypothesis *assuming, for the moment, that the underlying causes of expansion were the same in each of the four postwar periods.* According to this theory, one would have expected smaller short-run growth rates and a higher level of price instability in the first and last expansions, and a higher growth rate in real output and greater price level stability in the two middle expansions of Table I. However, in the two expansions where *primary* reliance was placed on velocity rather than money supply changes, i.e., where 73 to 78 percent of the growth rate in money GNP is accounted for by velocity growth as compared to 27 and 22 percent for the money supply growth rate, the price level as measured by the implicit GNP price deflator does *not* indicate a greater degree of stability. With respect to the short-term growth rates in real output, the picture is somewhat mixed with the 1958–60 period indicating a growth rate greater than that of the first expansion and equal to that of the fourth. This apparent anomaly, however, can perhaps be explained by the severity of the 1957–58 recession. Whereas the 1953–II to 1954–II and 1960–II to 1961–I peak-to-trough recessions in real terms declined on the average by

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$3.6 and $2.4 billion per quarter, the short-lived but intense 1957–III to 1958-I recession averaged a decline of $8.9 billion per quarter. And since the short-run output growth rates under consideration combine real growth with recovery from recession levels, the short-term growth rate of 1958–I to 1960–II can be regarded as a special case.

What this amounts to, however, is a relaxation of the assumption that the underlying expansionary forces were the same in each expansion, and it is here that a word of caution should be brought into the analysis. There are obvious dangers in assuming that similar phases of different cycles are of the same intensity, or the consequences of similar causes. It would be foolhardy to assume a simple casual relationship between money and velocity changes, on the one hand, and price and real output growth rates, on the other. The analysis will, therefore, be expanded to take into account the underlying forces behind each expansion by introducing budgetary data and the degree of capacity utilization. Fiscal policy will be represented, on the basis of quarterly data at annual rates, by the average combined Federal, state and local government surplus or deficit on income and product account for each period. The degree of capacity utilization will be approximated by comparing the actual unemployment rates with the Council of Economic Advisers' "interim" definition of full employment as 96 percent of the civilian labor force employed.

The 1951–53 period of Table I had an average $3.0 billion deficit and a 3.0 average unemployment rate. Yet despite an easy money policy, a budgetary *deficit*, and a state of over-full employment (using the CEA's definition), the price level grew at the modest rate of 1.6 percent. The 1954–57 period, by contrast, had a relatively tight money situation, a budgetary *surplus* of $0.9 billion, and an unemployment rate 0.6 percentage points above the "interim" full employment definition. Yet largely because of the capital goods boom of 1956–57, the price level grew at a rate of 2.8 percent—the highest in the entire post-Accord period. The last two periods of Table I had comparable degrees of under-capacity utilization (6.0 and 5.8 percent unemployment rates) and equal growth rates in real output. The 1958–60 expansion, however, had an average *passive* deficit of $4.5 billion(largely inherited from the sharp 1957–58 recession) compared with the *active* deficit of $0.4 billion for the 1961–65 period (with a movement from a slight surplus in 1963 to a $3.7 billion deficit in 1964 as a result of that year's tax cut). The passive deficit of 1958–60 represents an automatic movement along a fixed schedule of tax rates, whereas the average active deficit of 1961–65 (with its sharp discretionary turnaround in 1964) was the result of a downward shift in the tax schedules designed to reduce the fiscal drag of a built-in full employment budgetary surplus. Given the higher G_m and the *stimulative* deficit of 1961–65, one would have therefore expected a higher G_P for that period. This, however, was not the case, as can be seen from Table I.

It has already been noted that there is no easy mechanical relationship between money supply and price level growth rates, at least in the short-run. But keeping within the analytical framework of the safety-valve-plus-growth hypothesis, the differences observed in Table I are large enough to give some meaning to the comparisons made and to suggest that, contrary to the theory under consideration, a *primary* reliance on G_m rather than on G_v is to be preferred. At any rate, capacity and budgetary considerations do not seem to give any reason to alter this general conclusion.

V

It is, of course, true that the lengths of the four post-Accord expansions varied from 8 to 18 quarters. An alternate approach would be to compare the same relative proportion of each expansion. Table II does this by taking the last half of each expansion. These shorter periods allow for the inevitable lags associated with monetary policy. Though these lags cannot be ignored in assessing the effectiveness of general monetary controls, the shorter periods make it reasonable to assume that to some significant degree the recognition lag had been reduced and that the expansion up to the point of central bank action had not been excessive. A further implied assumption is that the central bank had correctly anticipated subsequent developments and acted promptly to correct them with minimal administrative and take-hold lags.[8]

[8] For a thorough discussion of the lag problem, *cf.* Thomas Mayer, "The Inflexibility of Monetary Policy," *Review of Economics and Statistics*, November 1958, pp. 358–74.

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TABLE II.—*Postaccord expansions (last half of each expansion)*

Period	Number of quarters	Average unemployment rate	Average budgetary surplus (+) or deficit (−) (billions)	G_y	G_m	G_v	G_p	G_q
1952-II to 1953-II	4	3.0	−5.1	8.3	3.2 (38.6)	5.1 (61.4)	1.4 (16.9)	6.9 (83.1)
1956-I to 1957-III	6	4.2	+5.3	5.6	0.6 (10.7)	5.0 (89.3)	3.8 (67.9)	1.8 (32.1)
1959-II to 1960-II	4	5.5	+2.4	3.7	−1.8 (−48.7)	5.5 (148.7)	1.6 (43.2)	2.1 (56.8)
1963-I to 1965-III [1]	9	5.2	+.6	7.2	4.2 (58.3)	3.0 (41.7)	2.0 (27.8)	5.2 (72.2)

[1] Not a peak quarter; latest data available.

Source: App. I, CEA Annual Reports, and Survey of Current Business, August 1965.

The two middle periods of Table II are of special interest. The extreme tightness of money is reflected in a G_m of 0.6 percent for the 1956–57 expansion and a *negative* G_m of −1.8 for 1959–60. Both of these cases represent an *exclusive* (rather than *primary*) reliance on velocity changes, and for this reason are not a true test of the safety-valve-plus-growth hypothesis. In both instances the short-term growth rates were unusually low. The virtually constant money supply in the 1956–57 period, however, did not prevent the price level from increasing at a 3.8 percent rate, and though the negative G_m for 1959–60 did succeed in limiting G_p to 1.6 percent it apparently did so at the expense of the short-term growth rate.

Though it would be dangerous to argue that a high growth rate in the money supply will necessarily promote a higher rate of growth in output, the risks are considerably less in arguing that a severely restricted money supply growth rate will impede the short-term growth rate—especially when the combined budget for all levels of government is in *surplus*. The average budgetary surplus on income and product account amounted to $5.3 billion for the 1956–57 expansion and $2.4 billion for the 1959–60 period. It seems reasonable to conclude that the two middle periods of Table II were sharply reined in by the unfortunate and perverse monetary and fiscal policies of the Eisenhower administration. Yet the 1956–57 period experienced the worst record on the price level front and the 1959–60 expansion was worse on this score than the 1952–53 expansion and not much better than the 1963–65 period. The relevant unemployment and budgetary data are listed in Table II. The average unemployment rates for the 1956–57 and 1959–60 expansions were 4.2 and 5.5 percent, respectively. The fiscal budget of the first easy money period (1951–53) was in *deficit* by $5.1 billion and in slight surplus ($0.6 billion) for the 1963–65 period. The average unemployment rates for each were 3.0 and 5.2 percent.

By every account the first and last expansions of Table II seem to have worked out better when compared to the tight money period of 1956–57. But a comparison of 1952–53 with 1963–65 does seem to indicate some support for the safety-valve-plus-growth hypothesis. The first period did have a *primary* reliance on velocity changes and did result in a slightly lower price level growth rate and a somewhat higher short-term rate of growth when compared to the fourth period with its primary reliance on G_m. The comparison, however, is not totally valid since the last expansion has not yet completed its course—1965–III is not a peak quarter; it is the latest quarter available at this writing. Furthermore, the first period of Table II does not represent the last half of the *full* expansion which dates back to 1948. The adjustment can easily be made by comparing the fourth period of Table II with the first period of Table I (which is closer to representing the last half of the 1948–53 expansion). In making this revised comparison, the anomaly of Table II disappears and the first and fourth expansions both represent a primary reliance on money supply increases with markedly higher output growth rates and a greater degree of price stability—with the exception of the 1959–60 expansion where the G_p rate was less than that of the fourth expansion and equal to the first period's. But the price

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paid for this achievement was a lower rate of output growth in view of the negative G_m rate and the fiscal surplus of $2.4 billion.

Hopefully, one inference can be drawn from Table II. The Federal Reserve, it seems, has learned its lesson and mended its ways. In the most recent expansion it once more returned to relying primarily on the money supply growth rate which, with the appropriate fiscal moves of 1964, has reaped a better overall performance of the economy with a reasonably stable level of prices. The sorry experiments of the Eisenhower administration with its emphasis on tight money and fiscal surpluses are behind us, and one would hope that that is where they will remain. The recent break of the "Fed" with the Johnson administration, however, does raise some serious doubts about the future.

The December 5, 1965 actions of the Federal Reserve System strongly indicate that the "Fed" is once more returning to the 1956–60 policy of restraining G_m and relying more heavily on G_v. In its "Announcement of Actions" published in the December 1965 *Federal Reserve Bulletin* it makes the following statement:

"The Federal Reserve [has taken] two complementary actions to reinforce efforts to maintain price stability * * *

"1. * * * increasing the discount rates * * * from 4 to 4½ percent * * * The action contemplates * * * the continued provision of additional reserves * * * in amounts sufficient to meet * * * the credit needs of an expanding economy without promoting inflationary excesses, primarily through the Federal Reserve's * * * purchases of U.S. government securities in the open market.

"2. Simultaneously, the Board increased the maximum rates that member banks are permitted to pay their depositors to 5½ percent on all time deposits and certificates of deposit having a maturity of 30 days or more * * *. The increase in the rates that member banks are permitted to pay their depositors is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy to finance their loan expansion."

Clearly, (1) contemplates a slowing down in G_m and (2) an increase in G_v in order to achieve the twin goals of price level stability and an adequate rate of economic growth. Apparently, the "Fed" is moving in the direction of the safety-valve-plus-growth approach to monetary policy. It is, of course, difficult to gauge at this time just how far the "Fed" will go in this direction, but it would seem more appropriate to maintain an adequate G_m (with lower interest rates) and a tighter fiscal budget as the policy mix for the achievement of short-run stability and long-term growth.

VI

One final item remains, and this will be dealt with summarily. The record of income velocity changes since the Accord raises some very interesting questions for monetary policy. An integral part of the safety-valve-plus-growth theory is the assumption that velocity changes are more like a rubber band than taffy; that a maximum stretching point will ultimately be reached at which point traditional monetary controls will take their full effect; and that in the process of stretching towards this maximum, the central bank is provided time and room in which to feel its way and turn around if necessary—thus minimizing the danger of overdoing things. The post-Accord record, however, does not indicate the existence of a velocity maximum. If it suggests anything it is that velocity has indeed the consistency of taffy, and that any action by the central bank to counter this continued stretching in the velocity of money will require an absolute reduction in the money supply with rather adverse effects on the rate of economic growth.

Using quarterly figures for the 3-month Treasury bill rate on new issues to represent the degree of credit availability (the two being, of course, inversely related) we can plot the quarterly velocity changes since the Accord of 1951 in Chart I to find the interest-velocity relationship with respect to time. At one point it was thought that the "shifts" of the interest-velocity curve were becoming smaller in magnitude and steeper in slope, thus indicating a rapid approach to the velocity maximum which would then make general monetary controls fully effective.[9] Chart I does not support this contention. The interest-velocity

[9] Cf. Peter L. Bernstein, "The Response of Income Velocity to Interest Rate Changes: A Comment," *Review of Economics and Statistics*, November 1960, and my "Rejoinder" in the same issue.

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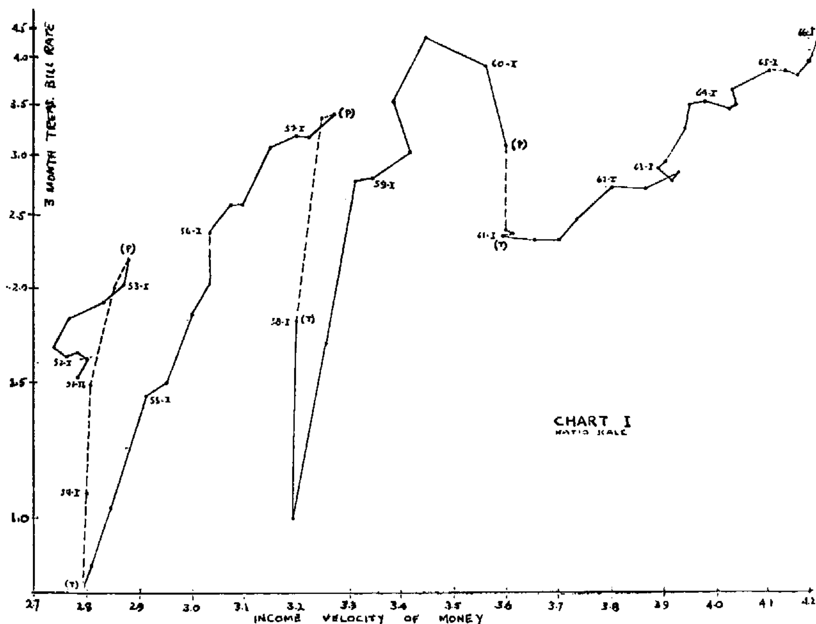
curve has shifted far to the right and has become flatter in slope with the 1965–III velocity figure standing at a record-breaking 4.1477, despite the fact that the bill rate is lower than the 4.299 rate in 1959–IV (at which time the velocity figure stood at 3.4542).

If, as it appears, velocity has more the consistency of taffy than the resiliency of rubber, the implications for monetary policy are rather grave. We would be living in a fool's paradise if we really hoped or believed that automatic, spontaneous, and uncontrolled changes in velocity during tight money periods would invariably be self-limiting, optimal and incapable of rupture.



*Appendix I**

	Y	M	V	P	Q	i
1951:						
II	325.8	117.2	2.7799	85.4	381.5	1.532
III	332.8	118.7	2.8037	85.6	388.7	1.628
IV	336.9	121.2	2.7797	86.7	388.7	1.649
1952:						
I	339.5	122.9	2.7624	86.7	391.4	1.640
II	339.1	123.8	2.7391	87.1	389.6	1.678
III	345.6	124.9	2.7670	87.7	393.9	1.829
IV	357.7	126.2	2.8344	88.3	405.3	1.924
1953:						
I	364.2	126.9	2.8700	88.4	412.1	2.047
II	367.5	127.7	2.8778	88.3	416.4 (P)	2.203
III	365.8	127.9	2.8600	88.4	413.7	2.022
IV	360.8	128.1	2.8165	88.4	408.8	1.486
1954:						
I	360.7	128.5	2.8070	89.5	402.9	1.084
II	360.4	128.8	2.7981	89.6	402.1 (T)	0.814
III	364.7	129.9	2.8075	89.5	407.2	0.870
IV	373.4	131.3	2.8439	89.8	415.7	1.036
1955:						
I	386.2	132.9	2.9059	90.2	428.0	1.456
II	394.4	133.8	2.9477	90.6	435.4	1.514
III	402.5	134.4	2.9948.	91.0	442.1	1.861
IV	408.8	134.5	3.0394	91.6	446.4	2.349

See footnote at end of table.

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*Appendix I**—Continued

	Y	M	V	P	Q	i
1956:						
I	410.6	135.2	3.0370	92.6	443.6	2.379
II	416.2	135.5	3.0716	93.4	445.6	2.597
III	420.6	135.5	3.1041	94.6	444.5	2.597
IV	429.5	136.1	3.1558	95.4	450.3	3.064
1957:						
I	436.9	136.5	3.2007	96.4	453.4	3.172
II	439.9	136.4	3.2251	97.1	453.2	3.157
III	446.3	136.4	3.2720	98.0	455.2 (P)	3.382
IV	441.5	135.7	3.2535	98.5	448.2	3.343
1958:						
I	434.7	135.7	3.2034	99.3	437.5 (T)	1.838
II	438.3	137.2	3.1946	99.7	439.5	1.018
III	451.4	138.5	3.2592	100.1	450.7	1.711
IV	464.4	140.3	3.3100	100.6	461.6	2.788
1959:						
I	474.0	141.6	3.3475	101.1	468.6	2.800
II	486.9	142.5	3.4168	101.4	479.9	3.019
III	484.0	143.0	3.3846	101.9	475.0	3.533
IV	490.5	142.0	3.4542	102.1	480.4	4.299
1960:						
I	503.0	141.0	3.5674	102.6	490.2	3.943
II	504.7	140.0	3.6050	103.0	489.8 (P)	3.092
III	504.2	139.9	3.6040	103.4	487.4	2.390
IV	503.3	139.3	3.6131	104.0	483.8	2.361
1961:						
I	503.6	140.2	3.5920	104.3	482.7 (T)	2.377
II	514.9	141.1	3.6492	104.5	492.9	2.325
III	524.2	141.6	3.7020	104.5	501.6	2.325
IV	537.7	144.0	3.7340	105.1	511.9	2.475
1962:						
I	547.8	144.0	3.8042	105.4	519.7	2.739
II	557.2	144.2	3.8641	105.5	527.9	2.716
III	564.4	143.9	3.9222	105.8	533.6	2.858
IV	572.0	146.2	3.9124	106.2	538.5	2.805
1963:						
I	577.0	148.7	3.8803	106.6	541.2	2.909
II	583.1	149.5	3.9003	107.7	544.9	2.941
III	593.1	150.7	3.9356	107.1	553.7	3.283
IV	603.6	153.0	3.9451	107.8	560.0	3.489
1964:						
I	614.0	154.7	3.9690	108.3	567.1	3.538
II	624.2	154.9	4.0297	108.4	575.9	3.481
III	634.8	157.3	4.0356	109.0	582.6	3.504
IV	641.1	159.2	4.0270	109.6	584.7	3.685
1965:						
I	656.4	160.0	4.1025	109.9	597.5	3.899
II	665.9	161.0	4.1360	110.7	601.4	3.879
III	676.9	163.2	4.1477	111.1	609.1	3.869
IV	679.2	166.2	4.1949	111.7	624.4	4.159
1966: I	714.1	168.5	4.2380	112.7	633.8	4.631

*Y=money GNP in current prices; M=demand deposits plus currency; V=income velocity of money; P=implicit GNP price deflator (1958=100); Q=real GNP in constant 1958 dollars; and i=3 month treasury bill rate on new issues.

Sources: Federal Reserve Bulletins, and Survey of Current Business (August 1965).

The CHAIRMAN. We will hear from the other witnesses before we ask questions and all the members will have a chance to ask questions.

The next on our list is Professor Klebaner, professor of economics, the City College of the City University of New York.

STATEMENT OF BENJAMIN J. KLEBANER, PROFESSOR OF ECONOMICS, THE CITY COLLEGE OF THE CITY UNIVERSITY OF NEW YORK

Mr. KLEBANER. I shall very briefly review the current scene and devote most of the time allotted to making some recommendations for improving the existing situation. My statement includes much more detail, of course, than I can present orally.

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It should be pointed out that the large denomination CD's are mainly the liabilities of the largest commercial banks in the Nation. Consistently, the banks with deposits of $500 million and over have been responsible for over four-fifths of the amount outstanding. The most recent report in February is that they had as much as 85 percent.

Furthermore, the secondary market for such negotiable CD's deals almost exclusively in denomonations of $100,000 and over. Originally the amount was a million dollars or more.

When Governor Robertson dissented from the December increase in regulation Q, and he was the only member of the Board to do so, he expressed the fear—

that the larger banks would be able to attract funds away from smaller financial institutions which did not actively engage in the issuance of time deposits, but relied on inflows of savings and demand deposits with which to meet loan demands.

As of March 31, this apparently had not yet occurred, if indeed it is going to occur at all.

Country member banks and nonmember banks combined—and these are by and large the smaller institutions in the system—had 51 percent of all commercial bank deposits, which was slightly above their share 2 years earlier before the current problem and agitation developed and the change in regulation Q.

These country member and nonmember banks had 47 percent of total commercial bank loans, slightly below what it was 2 years ago, but exactly the same as a year ago.

Now, these are, of course, very rough calculations. Unfortunately we do not have the data permitting a finer breakdown by size of bank. But they would seem to indicate that Governor Robertson's fears have not yet been justified.

One of the reasons for this is that the main buyers of CD's, the large corporations, do not usually keep sizable balances at small banks in any case, and the immediate impact of this money market instrument has been mainly felt by larger banks.

Savings deposits were 88 percent of all time deposits held by member banks at the end of 1960. Five years later they were only 70 percent. The maximum rate on savings deposits has been left unchanged from the 4-percent rate on deposits for 1 year or more effective January 1962, and the 4-percent rate on less-than-1-year money effective November 24, 1964.

Chairman Martin explained last December that the Board of Governors—

deliberately * * * decided * * * not to raise the ceiling on savings deposits so that the savings and loan associations and mutual savings banks would not be competitively seriously disrupted by the change in regulation Q.

By keeping the 4-percent rate, the Board of Governors intended—

to minimize the competitive impact between the mutual savings banks and the savings and loan people and the savings departments of the commercial banks.

Thus spoke Chairman Martin before the Joint Economic Committee.

Earlier liberalization of regulation Q was accompanied by vigorous growth in commercial bank time deposits. From 1962 through 1965 they increased 78 percent contrasted with the 55 percent rise in savings and loan associations.

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Going back somewhat in time, we may recall that as recently as 1949, commercial banks had three times as much in savings deposits as did the savings and loans.

Incidentally, the exact same ratio existed in 1930. But since 1949 there was a remarkable change in the picture of the savings and loan associations. They had only slightly less than commercial banks in January.

This very rapid growth has not always characterized the savings and loan industry. From 1932 to 1936 there was a shrinkage of one-third. And it took 9 years for the $4 billion in savings and loan accounts, which they reported in 1937, to double.

By January 1966, however, savings and loan accounts were 25 times what they had been at the end of 1937, whereas the interest-bearing deposits of commercial banks were only 9 times as large.

In April of this year, savings and loan associations suffered significant withdrawals. Should this persist on an important scale, then for the first time in a generation, this growth industry would face the problems of a major readjustment. For 1958 through 1964 customer withdrawals averaged twice as great as mortgage repayments, but the inflow of new savings more than offset this deficit.

Of course, one element determining this inflow has been the interest rate differential. For 1946 through 1961, savings and loans paid an average of 3 percent—twice the rate offered by commercial banks.

The spread of 1½ percent of a decade ago was reduced by the commercial banks to just under 1 percent in 1962 and it has shrunk further since that time.

Last December's revision permitted commercial banks to pay a rate on "other time deposits" significantly above the then prevailing rate offered by savings and loan associations for the very first time in the history of regulation Q.

The short-run prospect of the association's ability to prudently offer 5½ percent on 3 months' money is not very bright. Mortgage yields have moved up in recent months but most of the income of savings and loans comes from mortgages made at the lower rates of previous years.

The liquidity of commercial bank assets also decreased markedly during the current expansion as mortgages and municipals were acquired on a very large scale. Nevertheless, the loan and investment portfolio of commercial banks is toward the shorter term end of the spectrum. Commercial banks' current earnings can thus reflect current high rates much more readily than is the case with savings and loan associations.

The current tightness of the mortgage market is partly traceable to the shift of new savings away from the traditional leading lenders in this field.

The actual net change in mortgages during the first quarter of 1966, however, was no less than the preceding quarter and even $400 million above the level for 1965 as a whole. And commercial banks were lending at the same dollar volume.

The fear expressed by Chairman Horne before this committee that there would be a reduction of 50 percent or more in overall mortgage lending over an unspecified period is subject to some doubt. This development would indeed be startling. The record postwar shrink-

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age was in 1957, when the flow of all mortgage funds was one-fourth below the 1955 level and mortgages were down 31 percent.

It should be noted, however, that although housing declined by a fifth during the period 1955–57, total construction dropped only 3 percent.

Housing is not the only sector to feel the pinch of current money market conditions. Several tax-exempt offerings were canceled or postponed in March. The first quarter of this year saw a sharp cut-bank in commercial bank net acquisition of State and local bonds. For many years they have been the largest holders of these obligations. By 1965, commercial banks owned three-sevenths of all outstanding issues. Savings and loan associations have kept away from this segment of the construction finance market.

I turn now to a very rapid review of some proposals for dealing with the situation, both current and long run.

In dealing with the current situation, short-run palliatives must be clearly distinguished from long-run solutions. All three bills have little to recommend them as temporary devices, and are even more unsatisfactory as permanent measures. Eliminating the negotiability feature would diminish the effectiveness of these obligations. Interest-maximizing short-term investors would then look with greater interest on Treasury bills, short tax exempts, bankers' and commercial acceptances and so forth. The bill submitted by Representative Rees would have the Fed act to prevent any undue contraction of credit. But it is hard to imagine an altogether smooth major reshuffling of the liabilities and assets held in the money market or an adjustment which would not entail capital losses to at least some commercial banks.

The Rees bill would also have the effect of limiting other time deposits to a maturity of at least 1 year. The 1965 revision in regulation Q was the very first to establish uniform maximum rates for all time deposits. For the time being, it would not appear unreasonable to require that the rate for the under-91-day category not exceed the under-1-year savings deposit rate.

My recommendation is not intended to indicate approval of the third major provision of H.R. 15173 forbidding authorization of a higher return on any term of time deposit than is allowed for savings deposits held for 1 year or more.

The provision does not recognize that in practice banks waive the 30-day notice requirement, and pay savings deposits on demand. The time depositor, however, must wait for payment from the bank until the maturity date arrives.

Insisting that time deposits be issued for a term of at least 1 year would be a considerable departure from current banking practice. There are very few banks which have such a minimum term and certainly the maintenance of a liquid and solvent banking system does not call for this provision, as Governor Robertson testified last week.

H.R. 14422 is less drastic than the two bills just reviewed. The bill would preclude the banks from accepting time deposits in amounts under $15,000. At present very few member banks have such a high minimum. The bill would naturally affect smaller banks much more than larger ones.

Secretary of the Treasury Fowler, along similar lines, proposed that the Board of Governors, for a 2-year period, set a different ceiling

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on the first $10,000 of all time deposits. A 5-percent interest ceiling he thought would probably aid significantly "in deterring further large drains of funds from the specialized savings institutions."

At the end of 1964 a small fraction of all savings and loan balances, with about 30 percent of all dollar savings were in accounts with more than $10,000. For commercial banks the deposits over $10,000 represent over 45 percent of interest-paying deposits.

Larger balances are more interest-sensitive and the Fowler proposal may be an appropriate stopgap measure under existing circumstances. But none of the three bills represent a permanent solution. To avert the threat of future crises, fundamental revisions are needed.

Current difficulties of savings institutions stem from the very factors which were sources of strength in the early post-1945 period. Highly specialized financial institutions are vulnerable. Commercial banks are department stores of finance. Savings institutions now need to move in the same direction. Savings banks are currently seeking to become so-called family financial centers. There is also a trend toward greater expansion of the geographic limit of lending.

The mutual savings bank industry, as well as the savings and loan industry, needs to be given greater latitude in these dimensions.

At the same time, competition among financial intermediaries must be made more equal and there are four areas in particular that stand out in crying need of reform.

The first, reserve requirements; the second, capital requirements; the third, income tax treatment; and the fourth, interest ceilings.

Only commercial banks belonging to the Federal Reserve are required to keep nonincome yielding reserves against time deposits. If you compare the situation where the commercial banks are compelled to keep 4 percent of time deposits since late 1962, with the situation in savings and loans which at the end of last year had a cash deposit ratio of 3½ percent and the mutual savings banks had only 2 percent, one can easily see the obvious adverse impact on the earnings of member commercial banks.

The Board of Governors recently argued that "abolition of such reserve requirements would * * * increase the supervisory difficulties of bank regulatory agencies in insuring that the banks maintain adequate liquidity." If in fact that is true, then the rival financial institutions should also be subjected to comparable requirements as was recommended in 1963 by the Heller committee.

If the Board of Governors cannot demonstrate this, and I for one am skeptical, then the requirement should be eliminated altogether for all financial intermediaries.

If we turn to capital requirements, again we find that the commercial banks are expected to keep a higher ratio than their rivals.

Internal Revenue Code amendments in 1962 increased somewhat the tax liabilities of thrift institutions, but they still are very much lower than for commercial banks.

Finally, savings and loan institutions and savings banks have been free to pay savers rates based on business judgments, while commercial banks have felt the bind of regulation Q on occasion. From the standpoint of equity and economic efficiency, there would appear to be little justification for such unequal treatment.

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Regulation Q was one of a multitude of depression-spawned measures which restricted price competition. In 1961 the Commission on Money and Credit sponsored by the Committee for Economic Development, and 2 years later the Heller committee, both recommended that Q be placed on a standby basis. Rural savings institutions were to be covered as well.

The Heller committee suggested that the authority to set maximum interest rates would be invoked to help assure the continued safety of the institutions or "to promote the stability of economy," but note that all savings institutions would then be covered. Eventual removal of barriers to interest rate competition should be part of a comprehensive program to grant parity of treatment to all savings intermediaries. Such a program would seem to fit in well with the President's goal of "stronger competition and a more efficient flow of funds from savers to borrowers with the most urgent needs."

(The complete statement of Professor Klebaner follows:)

STATEMENT OF BENJAMIN J. KLEBANER, PROFESSOR OF ECONOMICS, THE CITY COLLEGE OF THE CITY UNIVERSITY OF NEW YORK

I. THE CURRENT SCENE IN PERSPECTIVE

Only one of the three dissenters from the discount rate increase of last December failed to approve the simultaneous change in regulation Q. By permitting commercial banks to pay higher interest rates, the Board of Governors "intended to enable the banks to attract and retain deposits of businesses and individuals and thereby to make more effective use of savings funds already available in the economy to finance their loan expansion." [1] Developments since December 6, 1965, however, have caused concern in many quarters and prompted these hearings. I am honored to appear before the House Banking Committee to testify on several bills intended to deal with the situation.

Commercial bank time deposits, only half as large as net demand deposits as recently as 1957, exceeded checking accounts in amount for the first time last year. Negotiable certificates of deposit (commonly referred to as CD's) represented about 15 percent of all member bank time deposits at the end of 1965.[2] In their desire to recapture corporate balances, large banks followed the lead of New York's First National City Bank in early 1961 in offering CD's. Depending on the issuer's size and standing, these short-term obligations yield one-fourth percent or more than the Treasury bill rate.[3] Expansion of CD's has slowed down. Weekly reporting member banks had $17.6 billion, as of May 11, 1966, $2.7 billion more than a year ago—an increase of only 18 percent. At the end of 1965, altogether 29 percent of all member banks issued CD's, among them 22 percent of the banks with under $10 million in deposits. Over 1,200 member banks sold them in denominations under $10,000, 195 in amounts under $100. Every one of the 75 member banks with at least one-half million dollars in deposits issues CD's, a majority confining themselves to denominations of $100,000 and over. These giants had 72 percent of all member bank CD deposits in early January. The quarterly surveys published regularly by the Board of Governors since August 1964 cover only denominations of $100,000 or more.[4] Weekly reporting member banks with deposits of one-half billion dollars and over have consistently issued over four-fifths of the large denomination CD's outstanding. Their share was 85 percent in mid-February 1966. (See table L.) The secondary market is confined to CD's in denominations of at least $100,000.

Just prior to the December change in regulation Q many banks were at the 4½-percent ceiling. When it was raised to 5½ percent the Board of Governors

[1] Board of Governors, Fifty-Second Annual Report (1965), p. 64.
[2] These and subsequent statistics on the time deposit picture as of December 1965–January 1966 are taken from "Time and Savings Deposits, Late 1965 and Early 1966," Federal Reserve Bulletin. LII (1966). 466–486.
[3] Richard Fieldhouse, Certificates of Deposit (Boston, 1962).
[4] Statistical release E.8 Maturity Distribution of Outstanding Negotiable Time Certificates of Deposit.

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did not expect many banks to pay the new maximum rate. Latitude was given to enable smaller banks to secure deposits in competition with larger institutions by offering a premium.[5] One supervisory official at the Fed was quoted at the time as warning that a bank going to 5½ percent would be "subject to discipline over its assets."[6] Recently some banks have gone to 5½ percent.

In his lone dissent from the December increase, Governor Robertson expressed the fear that "larger banks would be able to attract funds away from smaller financial institutions which did not actively engage in the issuance of time deposits but relied on inflows of savings and demand deposits with which to meet loan demands."[7] As of March 31, 1966, however, this had apparently not occurred. Country member banks and nonmember banks combined had 51 percent of all commercial bank deposits, slightly above their share 2 years earlier. These banks had 47 percent of total commercial bank loans, down 0.7 percent compared with March 31, 1964, but exactly the same as 1 year ago. (See table II.)

Large corporations, the main buyers of CD's, do not usually keep sizable balances at small banks.[8] The immediate impact of this money market instrument has been mainly felt by larger banks.

Savings deposits were 88 percent of all (IPC) time deposits held by member banks at the end of 1960. Five years later they were only 70 percent. The maximum rate on savings deposits was left unchanged from the 4-percent rate on deposits for 1 year or more effective January 1, 1962, and the 4-percent rate on less-than-1-year money effective November 24, 1964. Chairman Martin explained that the Board of Governors "deliberately * * * decided * * * not to raise the ceiling on savings deposits so that the savings and loan associations and mutual savings banks would not be competitively seriously disrupted by the change in regulation Q.[9] By retaining the 4-percent rate the Board intended "to minimize the competitive impact between the mutual savings banks and the savings and loan people and the savings departments of the commercial banks."[10]

Just over half of the net increase in total interest-bearing savings flowed to the commercial banks from 1962 through 1964. Their share jumped to two-thirds already in the first 9 months of 1965. In the first quarter of 1966 commercial banks captured almost five-eighths of a sharply reduced total.[11] At 4.8 percent of disposable personal income (according to preliminary estimates), personal saving was at an exceptionally low rate during the first quarter of 1966.[12]

Vigorous growth of commercial bank time deposits accompanied the earlier liberalizations of Q. From 1962 through 1965 they increased 78 percent, compared with a 55-percent rise in savings and loan balances.

As recently as 1949 commercial banks had 3 times as much in savings deposits as did savings and loan associations. (The same was also true in 1930.) But by the end of 1965 the multiple was only 1.2. Assets of savings and loan asociations at the end of 1965 were 7.5 times the level of yearend 1950 (when improved insurance payout provisions went into effect). Total assets of commercial banks were only 2.3 times as great.

But such rapid growth has not always characterized the savings and loan industry. From 1932 through 1936, there was a shrinkage of one-third. The $4.1 billion total accounts of 1937 took 9 years to double.[13] By January 1966 savings and loan accounts were 25 times the end-of-1937 amount, whereas mutual savings bank deposits were 5.2 times as great and commercial bank (IPC) interest-bearing deposits were 9 times as large as in 1937.

In April 1966, following the first quarterly interest date under the revised ceiling, savings and loan associations suffered significant withdrawals. If this

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[5] Joint Economic Committee, "Recent Federal Reserve Action and Economic Policy Coordination," hearings Dec. 13 and 14, 1965, p. 244.
[6] Business Week, Dec. 18, 1965.
[7] Board of Governors, Fifty-Second Annual Report, p. 70.
[8] Federal Reserve Bank of Chicago, Business Conditions, February 1964, p. 3.
[9] Joint Economic Committee, hearings, pp. 224–225.
[10] Ibid., p. 120.
[11] Here and elsewhere the Board of Governors most recently released flow-of-funds data have been used.
[12] Economic Indicators, April 1966, p. 5. In the first and second quarters of 1963 the rate was 4.7 percent.
[13] 1965 Savings and Loan Fact Book, p. 12.

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persists on an important scale, then for the first time in a generation this growth industry would face the problems of a major readjustment.

Customer withdrawals were twice as great as mortgage repayments from 1958 through 1964, but the inflow of new savings more than offset this deficit.[14] One element determining this inflow has been the interest differential.

From 1946 through 1961 savings and loans paid an average of 3 percent, twice the rate offered by commercial banks.[15] The banks reduced the 1½ percent spread of a decade ago, to just under 1 percent in 1962, and even less since then. Last December's revision permitted a rate on "other time deposits" significantly above the then prevailing rate offered by savings and loan associations for the first time in the history of regulation Q.

The short-run prospect of the associations being able to prudently offer 5½ percent on 3-month money is not very bright. Mortgage yields have moved up in recent months, but most of the income of savings and loans comes from mortgages made at the lower rates of previous years. Although the liquidity of commercial bank assets decreased markedly during the current expansion as mortgages and "municipals" were acquired, nevertheless the loan and investment portfolio of banks is toward the shorter term end of the spectrum. Banks' current earnings can thus reflect prevailing current higher rates much more readily than is the case with savings and loan associations.

Bank offerings are governed by estimates of the profitability of the uses to which the funds will be put.[16] Almost 2 years ago a Mellon National Bank official commented that CD operations represent "a low-profit segment of the business."[17] The situation has probably not changed significantly since then. Thus the ability of commercial banks to afford 5½ percent—especially as more and more time deposits move out of the savings category at 4 percent and into the higher interest rate segments—is also limited.

Current tightness in the mortgage market is partly traceable to the shift of new savings away from the traditional leading lenders.[18] In the first quarter of 1966 the net change in mortgages on one- to four-family properties was no less than in the preceding quarter, and 400 million above the 1965 level. Commercial banks were lending at the same dollar volume.

Commercial banks invested one-fourth of their record 1965 savings flow in new mortgages, compared to one-third in 1964.[19]

This record does not bear out Norman Strunk's statement that the banks "virtually ignored" home mortgages in 1965. However, his forecast that savings and loan associations "face retrenchment in home lending * * * unless something is done to ease this hectic rate war" is plausible.[20] Chairman Horne of the FHLB Board fears that a reduction of 50 percent or more in overall mortgage lending "seems likely" over an unspecified period.[21] This development would indeed be startling. The record postwar shrinkage to date was in 1957—when the flow of all mortgage funds was 25 percent below the 1955 level, and nonfarm 1–4-family mortgages were down 31 percent. It should be noted, however, that although housing declined 20 percent during this period, total construction dropped only 3 percent from 1955 to 1957.

Housing is not the only sector to feel the pinch of current money market conditions. Several tax-exempt offerings were canceled or postponed in March.[22] The first quarter of 1966 saw a sharp cutback in commercial bank net acquisitions of State and local bonds. For many years banks have been the largest holders of these obligations.[23] By 1965 commercial banks owned three-sevenths of all outstanding issues. Savings and loan associations have kept away from this segment of the construction finance market.

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[14] Ibid., pp. 22, 64.
[15] Ibid., p. 16.
[16] Fieldhouse, op. cit., p. 41.
[17] Business Week, July 18, 1964, p. 70.
[18] "Mutual Savings Banking, May 1966," National Fact Book, p. 43.
[19] Grover W. Ensley, "Savings Flows and the Mortgage Portfolio of Financial Institutions," address, Feb. 17, 1966.
[20] Statement before this committee, May 9, 1966.
[21] Statement before this committee, May 11, 1966.
[22] "Federal Reserve Bank of New York," Monthly Review, April 1966, p. 99.
[23] Raymond Goldsmith, "Flow of Capital Funds in the Post-war Economy," New York, 1965, p. 203.

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II. POLICY PROPOSALS

In dealing with the current situation, short-run palliatives must be clearly distinguished from long-run solutions. All three bills have little to recommend them as temporary devices, and are even more unsatisfactory as permanent measures. H.R. 14026 and H.R. 15173 would prevent insured banks from issuing further interest-bearing negotiable CD's or evidences of indebtedness.[24] Eliminating the negotiability feature would diminish the attractiveness of these obligations. Interest-maximizing, short-term investors would then look with greater interest on Treasury bills, short tax exempts, bankers' and commercial acceptances, etc. H.R. 15173 would have the Fed act "to prevent any undue contraction of credit," but it is hard to imagine an altogether smooth major reshuffling of liabilities and asset holdings in the money market, or an adjustment which would not entail capital losses to some commercial banks.

H.R. 15173 would also have the effect of limiting "other time deposits" to maturities of at least 1 year. The 1965 revision in Q was the first since 1935 to establish uniform maximum rates for all time deposits.[25] For the time being it would not appear unreasonable to require that the rate for the under-91-day category not exceed the under-1-year savings deposit rate.

This is not intended, however, to indicate approval of the third major provision of H.R. 15173, forbidding authorization of a higher return on any term of time deposit than is allowed for savings deposits held for 1 year or more. The provision does not recognize that in practice banks waive the 30-day notice requirement, and pay savings deposits on demand. The time depositor, however, must wait for payment from the bank until the maturity date arrives.[26]

Insisting that time deposits be issued for a term of at least 1 year would be a considerable departure from current banking practice. As of December 3, 1965, except for bank savings bonds, less than one-half of 1 percent of member banks had such a minimum term. Certainly the maintenance of a liquid and solvent banking system does not call for this provision, as Governor Robertson testified last week.

H.R. 14422 is less drastic than the two bills just reviewed. It would neither eliminate negotiable deposits and notes, nor prevent their issuance in any maturity at appropriate maxima determined by the Board of Governors. Rather, insured banks would be precluded from accepting time deposits in amounts under $15,000. Very few member banks have such a high minimum at present. The bill would affect smaller banks more than larger ones.

Somewhat along the lines of this bill, Secretary of the Treasury Fowler proposed to deal with "this temporary transitional problem" by empowering the Board of Governors for a 2-year period to set a different ceiling on the first $10,000 of all time deposits. Balances protected by the FDIC "should be prepared to receive a slightly lower rate on the insured amounts," he argued. A 5-percent ceiling on the first $10,000 of all time deposits would probably aid significantly "in deterring further large drains of funds from the specialized savings institutions."[27]

At the end of 1964, 6.6 percent of all savings and loan balances, with 31.4 percent of all dollar savings were in accounts with more than $10,000. For the 327 insured mutual savings banks the corresponding shares were 6.6 percent and 39.8 percent, and for commercial bank (IPC) savings and time deposits, 2.7 percent and 45.7 percent.[28] As larger balances are more interest-sensitive, the Fowler proposal may indeed be an appropriate stopgap measure under existing circumstances.

None of the three bills under consideration represents a permanent solution. To avert the threat of future crises, fundamental revisions are needed.

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[24] The measures are presumably not intended to affect the issuance of long-term capital notes and debentures.

[25] From 1936 to 1964 those payable in 90 days or less yielded 1½ to 2½ percent less than savings deposits held for 1 year. In 1964 they were placed on a par with savings deposits.

[26] Q permits payment before maturity in an emergency, at an interest penalty.

[27] Testimony, May 19, 1966, supra.

[28] 1965 Savings and Loan Fact Book, p. 20; FDIC Annual Report, 1964, pp. 119 ff.

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Current difficulties of savings institutions stem from the very factors which were sources of strength in the earlier post-1945 period. Highly specialized financial institutions are vulnerable. Commercial banks are "department stores of finance." This is the product of a long evolution which has also seen such once-confined organizations as trust companies, industrial banks, and stock savings banks develop into full-range commercial banks despite their names. Specialized savings institutions now need to move in the same direction.

Currently savings banks are seeking to become "family financial centers."[29] Federal chartering may stimulate the development of more rounded activities. Geographic expansion of lending scope is also needed. New York has just permitted its savings banks to invest up to one-fifth of their funds in conventional out-of-State mortgages. The mutual savings bank industry currently has almost 30 percent of its mortgages on property in the 32 nonsavings bank States.[30] Since 1957 insured savings and loan associations have been allowed to participate in mortgages outside their usual lending area; some 5 percent of their loans were of this sort by the end of 1964.[31] Further liberalization is indicated if funds are to move to the points of greatest need.

At the same time that financial intermediaries are given greater scope, competition between them must be made more equal. Four areas stand out as especially in need of reform: (1) Reserve requirements, (2) capital requirements, (3) income tax treatment, and (4) interest ceilings.

Only member commercial banks need keep legally governed cash reserves against time deposits. The current 4-percent rate has been in effect since late 1962. The Board of Governors is empowered to vary this reserve requirement from 3 to 6 percent. Savings and loans had a cash-deposit ratio of 3½ percent at the end of 1965, and mutual savings banks, only 2 percent. This has an obvious adverse impact on the earnings of member commercial banks.

If in fact the Board of Governors can demonstrate that "abolition of such reserve requirements would * * * increase the supervisory difficulties of bank regulatory agencies in insuring that banks maintain adequate liquidity",[32] then rival institutions should also be subjected to comparable requirements, as the Heller committee recommended.[33] If not, the requirements should be eliminated altogether.

Capital requirements, essentially determined by the regulatory agencies, bear unequally on competing intermediaries. End 1965 saw the capital deposit ratio for commercial banks at 9.4 percent, while for savings and loans it was 7.9 percent, and for mutual savings banks 8.9 percent.

In 1962 revisions in the Internal Revenue Code increased the obligations of the rival nonprofit intermediaries, but they continue to enjoy advantages over commercial banks. Perhaps the time-deposit activities of commercial banks could be segregated and all savings institutions given identical tax treatment.

Savings and loans and savings banks have been free to pay savers rates based on business judgments, while commercial banks have felt the bind of Q on occasion. From the standpoint of equity and economic efficiency, there would appear to be little justification for such unequal treatment.

Regulation Q was one of a multitude of depression-spawned measures which restricted price competition. In 1961 the Commission on Money and Credit and 2 years later the Heller committee recommended that Q be placed on a standby basis; rival savings institutions were to be covered as well. The authority would be invoked "to help assure the continued safety of the institutions or to promote the stability of the economy."[34]

Eventual removal of barriers to interest-rate competition should be part of a comprehensive program to grant parity of treatment to all savings intermediaries. Such a program would seem to fit in well with the President's goal of "stronger competition and a more efficient flow of funds from savers to borrowers with the most urgent needs."[35]

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[29] Mutual Savings Banking, May 1966, p. 4.
[30] Ibid., p. 12.
[31] 1965 Fact Book, p. 69.
[32] Joint Economic Committee, loc. cit., p. 590.
[33] Report of the Committee on Financial Institutions (Washington, 1963), pp. 17–18 cf. Report of the Commission on Money and Credit, p. 69.
[34] Heller report, p. 24.
[35] Economic Report of the President, 1966, p. 19.

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TABLE I.—*Outstanding negotiable CD's 100,000-plus denominations—percent in weekly reporting member banks*

	Total number of banks	Total deposits in millions					Total amount (in millions)
		Under 100	100-200	200-500	500-1 billion	Over 1 billion	
Aug. 19, 1964	249	1.4	2.6	13.4	16.6	66.0	$12,193.4
Nov. 18, 1964	253	1.2	2.5	12.6	16.1	67.7	12,740.4
Feb. 17, 1965	256	1.2	2.6	13.1	15.6	67.6	13,747.2
May 19, 1965	248	1.0	2.1	11.4	14.0	71.5	15,057.5
Aug. 18, 1965	249	1.1	2.2	11.3	14.2	71.2	16,008.6
Nov. 17, 1965	245	1.1	2.3	11.1	14.5	71.0	16,367.6
Feb. 16, 1966	250	1.2	2.3	10.9	14.3	71.3	16,356.3

Source: Board of Governors, Federal Reserve System.

TABLE II.—*Total loans and deposits, Mar. 25, 1964, and Mar. 31, 1965 and 1966*

	Loans (percent)			Deposits (percent)		
	Mar. 25, 1964	Mar. 31, 1965	Mar. 31, 1966	Mar. 25, 1964	Mar. 31, 1965	Mar. 31, 1966
New York City reserve city banks	15.1	16.1	16.6	13.9	15.0	14.5
Chicago reserve city banks	3.9	4.0	4.0	3.7	3.7	3.6
Other reserve city banks	33.4	32.8	32.5	31.8	31.4	30.8
Country banks	32.1	31.3	31.3	33.9	33.1	33.9
Nonmember banks	15.6	15.7	15.7	16.8	16.8	17.1
All commercial banks (in billions)	$156.8	$179.0	$203.5	$272.1	$300.8	$320.1

Source: Federal Reserve Bulletin.

The CHAIRMAN. Thank you, sir.

The next witness is Dr. Deane Carson, professor of banking, Columbia University.

Doctor, we are glad to have you.

STATEMENT OF DEANE CARSON, PROFESSOR OF BANKING, COLUMBIA UNIVERSITY

Mr. CARSON. Mr. Chairman, if I may, I would like to read part of my statement without going beyond the bounds of the 10 minutes.

The CHAIRMAN. That will be all right.

Mr. CARSON. I have followed the present hearings with considerable interest, and have concluded that my testimony should be limited to a rather broad interpretation of the issues, since most of the facts have been amply presented.

With this restraint in mind, I shall first deal with the specific impact of CD's in the financial structure, and then attempt to relate the present problem to the more general, and I think more important, problem of Government's role in shaping the course of financial intermediation. To anticipate the conclusions of the latter, I contend that our present concern with the regulation of CD's—actually, a subproblem under regulation Q—should be considered in the context of an overall review of public policy toward the desired level of competition between commercial banks and other thrift institutions.

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Innovation is a characteristic of vital and responsive financial institutions. The essential necessity of competing for scarce loanable funds in financial markets has produced a remarkable amount of innovating activity in recent years. The revival of the Federal funds market in the 1950's the development of repurchase agreements in the Government securities market, the increasing complexity of bank capital structures, the development of nonprice inducements to open savings accounts of that institution, the phenomenon of money brokers with tie-in agreements—all of these are quite natural responses of a market in which competing demands for funds tend to outrun supply of funds at current prices. Government regulations—including monetary policy, have stimulated these innovations.

The innovation with which we are concerned today, certificates of deposit, was fostered by a combination of growing competition from nonbank financial concerns, by general monetary policy, and by the simple, old-fashioned response of a seller to his buyers' needs. While the first two of these forces set the stage for the innovation of negotiable and ordinary certificates of deposit, the latter is both the crucial and the most neglected explanation of the origin and development of CD's.

The essential innovative quality of CD's is the fact that corporate treasurers, and other depositors, are enabled to enter into contracts to place funds with commercial banks for periods of time that closely approximate the depositors own needs for funds.

As I point out in my statement, this is not an absolutely unique instrument, money market instrument, since there are somewhat close substitutes, including Treasury bills and repurchase agreements. The point here is, however, that for all lenders to banks as depositors, the CD, particularly the negotiable CD, offers perhaps the most tailored instrument to the lender's needs.

I think we all recognize that financial as well as all kinds of innovations create problems for the innovator as well as for his competitors. CD's, particularly the negotiable variety, have drained funds from competing financial institutions, including other banks. This has been a source of embarrassment to those institutions who felt that the rules of the game, as specified by regulation Q, would not be changed. These firms were short of liquidity when regulation Q was raised to 5½ percent in December. Adjustment to the new rules of the game has been painful. The pertinent question here is whether the actual or potential benefit to society is greater than the cost.

I contend that the bills under consideration before this committee tend to treat the symptoms of the problem rather than the disease itself. The symptom that I observe is periodic liquidity shortages for some banks—and generally speaking, these are very large banks, although the problem exists for very small ones, too, at times. That is a symptom. This symptom arises whenever competing interest rates tend to rise about regulation Q or where the differential between the maximum rate that commercial banks can pay on deposit and competing rates is narrowed. In this context people looking for the highest return tend to shift their funds to other commercial banks and to other assets.

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Obviously, then, it is not the existence of the certificate of deposit that creates the problem but really the existence of regulation Q itself.

My proposal today is that we very seriously examine the necessity for regulation Q. My own view is that regulation Q, like every other kind of price control imposed by government, creates at least as many problems as it solves and in this case I, at least, am very convinced that regulation Q is at the heart of the problem.

Now, in terms of the individual bank's ability to contend with the existence of this new money market instrument, I would like to note that the problem of CD's involves management decisions that are not unlike those involving any other kind of deposits. In some respects the management of assets becomes a smaller problem when the bank manager knows the exact maturity dates of his liabilities. Demand deposits are subject to more or less definable and predictable fluctuations and so are ordinary savings deposit swings into and out of a given institution. An astute manager can tailor negotiable CD's to loan commitments, to cash flows, and to reserve requirements without long-range difficulty; that is, if there is coordination between the input and output parts of the bank. Any bank that is too small or otherwise disinclined to perform this management function should not engage in the business of negotiable certificates of deposit. However, I do not believe they should be proscribed from doing so by law.

I would like to state or reaffirm my faith in the individual entrepreneur in banking. I think this is one of the bases of our market and free enterprise system. Unfortunately, I think we have tended to interfere unduly to overregulate this particular segment of our economy, but these regulations were generated under crisis situations relating mainly to the early 1930's. I think it is time to rethink our entire regulatory philosophy with respect to the banking system, in particular, and to the spectrum of financial institutions in general.

Without this examination I think we simply will go onward, treating each crisis as an ad hoc situation, trying to develop specific solutions to specific problems without ever developing an overall context within which we must operate public policy vis-a-vis financial institutions.

I would like to conclude by noting that these bills have the odd effect of discriminating against small depositors. This I don't think is intended, but may I draw your attention to the fact that if one is limited to $25,000—if a bank is limited to accepting only CD's or time deposits of $25,000 and over, that this effectively prohibits or discriminates against small depositors, most of whom would have certainly less than $25,000.

The same thing is true, incidentally, of the situation under regulation Q today, where the ordinary savings depositor can only earn 4 percent and the corporate treasurer can earn 5½ percent as a maximum. I see no reason for this discrimination against one class of depositor.

Thank you.

(The complete statement of Professor Carson follows:)

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STATEMENT OF DEANE CARSON, PROFESSOR OF BANKING, COLUMBIA UNIVERSITY

Mr. Chairman, my name is Deane Carson, professor of banking at Columbia University.

I welcome the opportunity to participate in this study of the role of CD's in the financial structure of the American economy. This committee has substantially contributed to the understanding of financial relationships and institutions over the past several years. I have followed the present hearings with considerable interest, and have concluded that my testimony should be limited to a rather broad interpretation of the issues, since most of the facts have been amply presented.

With this restraint in mind, I shall first deal with the specific impact of CD's in the financial structure, and then attempt to relate the present problem to the more general—and I think more important—problem of Government's role in shaping the course of financial intermediation. To anticipate the conclusions of the latter, however, I contend that our present concern with the regulation of CD's—actually a subproblem under regulation Q—should be considered in the context of an overall review of public policy toward the desired level of competition between commercial banks and other thrift institutions.

Innovation is a characteristic of vital and responsive financial institutions. The essential necessity of competing for scarce loanable funds in financial markets has produced a remarkable amount of innovating activity in recent years. The revival of the Federal funds market in the 1950's, the development of repurchase agreements in the Government securities market, the increasing complexity of bank capital structures, the development of nonprice inducements to open savings accounts, the phenomenon of money brokers with tie-in agreements—all of these are quite natural responses of a market in which competing demands for funds tend to outrun supply of funds at current prices. Government regulations—including monetary policy—have stimulated these innovations.

The innovation with which we are concerned today, certificates of deposit, was fostered by a combination of growing competition from nonbank financial concerns, by general monetary policy, and by the simple, oldfashioned response of a seller to his buyers needs. While the first two of these forces set the stage for the innovation of negotiable and ordinary certificates of deposit, the latter is both the crucial and the most neglected explanation of the origin and development of CD's.

The essential innovative quality of CD's is the fact that corporate treasurers, and other depositors are enabled to enter into contracts to place funds with commercial banks for periods of time that closely approximate the depositors' own needs for funds. In itself, this feature is not unique to CD's. The Treasury bill market, and the device of repurchase arrangements between bond dealers and corporate treasurers comprise close substitutes for CD's, and antedate the latter innovation by many years. CD's thus constitute a relatively recent addition to the spectrum of assets by which lenders economize on cash balances.

These instruments—money market assets—are not perfect substitutes. Repurchase agreements between Government bond dealers and corporate treasurers typically have a maximum maturity of approximately 2 weeks, and more often less, and are tailored to the lender. Corporate and other lenders often need accommodation on longer term; this gap has been filled by CD's which are contracted for a specific date and on specified terms.

Treasury bills also constitute a close, but not perfect, substitute for CD's. The nonnegotiable CD is less liquid than either the Treasury bill or the negotiable CD. Considering the latter alone, the substitution is almost perfect; the cost of purchase of bills is almost certainly offset by negotiating the certificate of deposit. Thus, when bill yields fall, the attractiveness of CD's increases, and when yields rise, lenders tend to move their free funds toward Treasurys.

From the lender (depositor) view, therefore, the effect of CD's, particularly the more negotiable CD's, is more efficient cash management, and a lower opportunity cost of holding cash balances than would otherwise be the case.

All financial innovations create problems for the innovator as well as his competitors. CD's, particularly the negotiable variety, have drained funds from competing financial institutions, including other banks. This has been a source of embarrassment to those institutions who felt that the rules of the game, specified by regulation Q, would not be changed. These firms were short of

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liquidity when regulation Q was raised to 5½ percent in December. Adjustment to the new rules of the game has been painful. The pertinent question here is whether the actual or potential benefit to society is greater than the cost. Preventing or restricting natural development of financial institutions can only be justified if there is a clear showing that benefits of unrestricted competition will be less than the cost.

In terms of the individual bank, the negotiable CD problem involves management decisions that are not unlike those involving any other accretion of deposits. In some respects, the management of assets becomes a smaller problem when the manager knows exact maturity dates on the liability side of the balance sheet. Demand deposit levels are subject to more or less definable and predictable fluctuations; and so are ordinary savings swings into and out of a given institution. An astute manager can tailor negotiable CD's to loan commitments, to cash flows, and to reserve requirements without long-range difficulty; if there is coordination between the input (deposit-generating) and output (lending-investing) parts of the bank. Any bank that is too small or otherwise disinclined to perform this management function should not engage in the business of negotiable certificates of deposit. However I do not believe they should be proscribed from doing so by law.

Turning to the question of the impact of CD's on financial institutions in general, we observe a significant inflow and outflow over time of funds from mutuals and savings and loans to time and savings accounts in commercial banks. Those ebbs and flows largely reflect relative rates of return to depositors. This is a natural and desirable flow. Unfortunately, however, as in late 1965, the existence of regulation Q not only distorts the allocation of funds to those institutions that can pay the highest rates, but also creates a liquidity situation of near-crisis proportions. Rather than blame the issuers of negotiable CD's, our efforts should be directed to eliminating regulation Q which, after all, is the source of the problem.

At the same time, I would urge the relaxation of those restrictions that have tended to confine the activity of S & L's and mutual savings banks to residential mortgages. This will enable them more effectively to compete with the emerging department stores of finance, the commercial banks. I wish to turn now to a fundamental issue that the current CD debate raises.

Behind the current controversy concerning the use of certificates of deposit by commercial banks as a source of loanable funds lies a more fundamental question and problem. Briefly, this concerns our basic philosophy—or lack of a clearly defined philosophy—concerning the proper role of government control of competition between various types of financial institutions.

We have yet to settle several important issues in this respect. The growth in financial institutions and their activities has occurred in a regulatory and legislative framework that was largely the product of crisis and depression in the third decade of this century. Our overall regulatory philosophy—with a few notable exceptions—has not kept pace with the vast expansion of our financial institutions, and their ever-changing roles in meeting community needs for finance.

First of all, I believe we need to determine, at least in general terms, whether we wish to strengthen or diminish the area within which relative prices in the financial marketplace are allowed to determine the allocation of funds to various kinds of financial intermediaries.

Second, we need to determine whether to increase or diminish regulatory controls that limit the assets that various financial institutions can accumulate; in other words, whether to interfere more or less than we now do in the choices that are available to commercial banks, savings and loan associations, mutual savings banks and credit unions with respect to their business activities.

These are hard questions that deserve long-range answers. Unfortunately, as I interpret the record, we tend to seek answers ad hoc to meet specific situations, often in response to cries or monetary phenomena.

Having raised these fundamental issues, I hasten to assure you that the answers are not readily at hand. Indeed they raise difficult questions that require knowledge far beyond that which is currently available. Specifically, we need to know considerably more than we do about the costs and benefits of our current restraints on interinstitution competition, and about the probable costs and benefits of both more and less government interference.

The CHAIRMAN. Thank you, sir.

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Mr. Rousseas, I want to ask you a question about the reserves. You mentioned that in your paper in an interesting way. How can you use CD's to increase reserves in a bank? Just tell me how it is done.

Mr. ROUSSEAS. This I think is a very important issue. Let me illustrate this by comparing CD's with Treasury bills.

In the past when the Federal Reserve would put pressure on commercial bank reserves the banks were in the position to sell Treasury bills or refuse the refunding operations of the Treasury with regard to short-term Government obligations. They were, in effect, changing the internal composition of their earning assets by converting investments into loans.

When we come to CD's (and this is where the uniqueness of CD's comes in), induced shifts from demand to time deposits within the commercial banking system do not affect the total reserves of the banking system as a whole. Required reserves, however, do change.

The CHAIRMAN. They average these reserves.

Mr. ROUSSEAS. Yes. In the CD case excess reserves increase because you reduce required reserves. And this follows from the fact that on the average we have a 15-percent reserve requirement on demand deposits and 4-percent reserve requirement on savings and time deposits. And this leads us back to my suggestion, for abolishing not only the distinction between city and country banks, but also the differences in reserve requirements.

The CHAIRMAN. I know, but you are going beyond my question. That is a very interesting discussion, but the question I asked is how these CD's are used to affect reserves. Suppose you buy a million dollars worth of CD's from a bank this morning—how would they handle that? They could put all that in their reserve fund, could they not, if they wanted to?

Mr. ROUSSEAS. Let me explain it this way. The question is of course, who buys the CD. Let's say a corporation decides to buy a million dollar CD. How does it pay for it? It pays for it with a check against its demand deposits. Consequently demand deposits fall and time deposits increase.

The CHAIRMAN. From 16 to 4.

Mr. ROUSSEAS. That is right, with regard to reserve requirements.

The CHAIRMAN. Banks have demand deposits—it used to be half and half. So in effect it is about a 10-to-1 ratio, 4 and 16 is 20. That would be a 10-percent ratio for reserves. That would be that in making loans?

Mr. ROUSSEAS. One way of looking at this, is to take the amount of the switch from the demand to time deposits and multiply this by the difference between the reserve requirement on demand deposits minus the reserve requirement on time deposits.

The CHAIRMAN. Please get back to this corporation that buys a million dollars and whether it is a check or money, it is all the same as far as the banking system is concerned. That is correct, is it not?

Mr. ROUSSEAS. That is not quite right. A corporation is not likely to pay for a CD in cash.

The CHAIRMAN. All right. Now, of course each member bank of the Federal Reserve has an account at the Federal Reserve just like we have at commercial banks. The account they have with the Fed is composed of high powered dollars. That is right, is not? High

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powered dollars? And could all this million on this be invested in high powered dollars? In other words, it could be deposited there with the Fed, could it not?

Mr. ROUSSEAS. Mr. Chairman, may I do it—there is a very simple answer to this. I would have to check your arithmetic and the ratios involved, but I simply take the required reserves on demand deposits minus the required reserve on time deposits times the amount of the switch from demand to time deposits and this would give you the amount of excess reserves generated. Then the commercial banking system as a whole could increase its loans and therefore its secondary demand deposits by some multiple of the newly created excess reserves, that is, by the reciprocal of the average reserve requirement plus leakages.

The CHAIRMAN. That does not answer my question. Suppose this corporation delivered a million dollars in actual cash for a certificate of deposit at 5½ percent. It could take that million dollars and deliver it to the Fed, could it not?

Mr. ROUSSEAS. Yes.

The CHAIRMAN. And have a million dollars more in its reserve account. That is correct, is it not?

Mr. ROUSSEAS. That is correct.

The CHAIRMAN. That would enable that bank to make loans, assuming——

Mr. ROUSSEAS. Not for the full amount.

The CHAIRMAN. And so the ratio would be about 10 to 1, would it not?

Mr. ROUSESAS. Where do you get your 10 to 1 figure?

The CHAIRMAN. On the demand deposit, 16 percent, and 4 percent on the time deposit. May commingle these funds; that is generally accepted practice?

Mr. ROUSSEAS. Yes.

The CHAIRMAN. That is an average of 10 percent instead of 16 percent. It is 10 percent. So that is 10 to 1. They can make loans and investments equal to 10 to 1 on that, could they not?

Mr. ROUSSEAS. Yes.

The CHAIRMAN. You have to say that, I think.

Mr. ROUSSEAS. Yes.

The CHAIRMAN. So, therefore, whenever you sell a certificate of deposit in a bank and acquire this money for it, that money could go into the reserve account if it wanted to and, of course, increase its loan potential. Therefore, the Federal Reserve System is in effect losing its control to that extent over its power to effect reserves, is it not?

Mr. ROUSSEAS. That is absolutely correct, Mr. Chairman, provided the corporation paid for the CD in cash, which is not the usual practice.

The CHAIRMAN. Do either of you deal with that in your paper?

Mr. ROUSSEAS. Yes, I do, quite explicitly, but through the used-demand deposits for the purchase of CD's.

The CHAIRMAN. It occurs to me the Fed in permitting this innovation—I consider it an innovation—although they had a billion dollars outstanding at the end of 1960—it is on the chart over there—and by the end of December last year there was about $16.5 billion which is unusual, unheard of in banks. The reason I think this took place is

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that they were getting the people that wanted to raise short-term rates on Government securities. They wanted to get these huge corporate funds out of the short-term market. They were down here on each Monday bidding. They felt that we can get them away from these Treasury auctions and get them into these CD's, then the short-term Government-interest rates would go up and that's exactly what happened, is it not? As they took their money out of the short-term Government securities market and put it in CD's then the short-term Government market yields went up, did it not?

Mr. ROUSSEAS. I'm not sure of the motivations involved but short-term interest rates did go up, excess reserves were generated and the lending power of the commercial banking system did increase.

The CHAIRMAN. And the Fed was losing its power to control the reserves all the time, was it not?

Mr. ROUSSEAS. Let me put it in my terms, Mr. Chairman. One of the things we were told in the postwar period was that monetary policy had become a very delicate instrument which would require only small changes in interest rates. The irony as I see it, and I put this in my written statement, is that the alternate theory of Gurley-Shaw expected that monetary policy would be compromised by the rapid growth of nonbank financial intermediaries. In effect, the CD's have converted the commercial banking system into their own non-bank intermediaries thus giving them additional power to increase the income velocity of money. The activation of idle balances, in other words, has acted as an offset to the monetary policies of the Federal Reserve System. As a result, the Federal Reserve has to take progressively larger and still larger open market operations to counteract the velocity changes which, in the case of CD's, are the Fed's own doing. They have encouraged banks to use CD's.

The CHAIRMAN. My time has expired. I will yield to Mr. Weltner, but I would like to state that I appreciate the fact you are advocating Federal Reserve reform. Very few economists will do that and, of course, I sympathize with people who do. Where I was born there was a saying that you could dig more snakes than you can kill. It is never a good idea to do that. People are pretty cautious of digging up snakes to kill. I can see where a professor would be somewhat on thin ice. I do not blame them for not being too forthright. You have been unusually forthright.

Mr. ROUSSEAS. May I take this opportunity to be even more forthright in stating my views on the independence of the Federal Reserve. There has been so much said about the independence of the Federal Reserve and I would like to point out there are two senses of "independence": one is the independence of the Federal Reserve from the Congress with regard to appropriations, which I very much favor, and the other is the independence of the Federal Reserve from the executive branch of Government. I think it is a peculiar characteristic of our own monetary system that we can talk about the independence of monetary policy from the political party in power, as though there were something sacred and apolitical about monetary policy. I think one of the ways of resolving the issue of the independence of the Federal Reserve from Treasury pressure would be to set up a Department of Economic Affairs on Cabinet rank. After all, we have now a Department of Urban Affairs, and a Department of Transportation and

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we consolidated the Army, the Air Force, and the Navy some time ago into a Department of Defense.

The issues we are involved with here are of such great importance to the economic growth and performance of this country that I am rather nonplussed to see all these extra Cabinet Departments being set up when, from my point of view, the major need has been ignored. In my schema the Treasury and Federal Reserve would both be subordinated within this Department of Economic Affairs.

The CHAIRMAN. Well, in my Joint Economic Committee hearings in 1952, we went into that with Mr. Snyder who was Secretary of the Treasury. He advocated something along that line.

Mr. Weltner?

Mr. WELTNER. Thank you, Mr. Chairman.

Professor Rousseas, I was interested in the chairman's comment that by converting demand deposits into CD's the Federal Reserve loses control. It is correct, is it not, that it loses control only insofar as the diminished requirements from a 16 to a 4 percent reserve? Is that correct?

Mr. ROUSSEAS. That is correct.

Mr. WELTNER. So if a company has a million dollars in the demand account, the bank must retain a 16-percent reserve or $160,000. Of that money, $120,000 would be freed for regular commercial bank activities by conversion. Consequently, the conversion of demand into time deposits has a substantial effect on increasing it.

Mr. ROUSSEAS. The Federal Reserve System is, of course, very much aware of this.

I would like to read a very brief quotation from the president of the Federal Reserve Bank of New York, Mr. Alfred Hayes:

> It is true, of course, that with a given total volume of reserves the banking system can extend a greater volume of credit the more heavily weighted its deposits are with time deposits, since reserve requirements against such deposits are relatively low. But, after all, the System can create as few or as many reserves as it deems appropriate to existing circumstances.

President Hayes is quite correct in this. I would not be willing to say that the Fed loses all control. I think it would be more accurate to say that it has to act in ever larger steps in its open market operations to bring matters under control. There is some question in my mind whether it can do so on an adequate basis. So the question is not one of having total control or none at all. But the fact remains that the commercial banking system does have the power, at least in part, to offset the pressures put upon it by the monetary authorities.

What troubles me is, that monetary policy is not the delicate instrument that the availability of credit doctrine told us it would be in the postwar period.

Mr. WELTNER. I would like now to ask Dr. Carson, what would happen if, instead of the Congress passing some limitation as to amounts or maturities, we simply passed a bill that states that savings and loan associations and mutual savings banks shall hereafter have the authority to issue savings certificates or appropriate documents bearing essentially the same characteristics with regard to maturities, terms, and amounts as those issued by commercial banks? What would be the effect of that? I ask that question with the knowledge that the Home Loan Bank Board has the power to provide such

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equality, but only recently has the Home Loan Bank Board exercised a part of that power. Would that create a free economy? Would that avoid the problem of compartmentalizing banking and financial institutions? Would that obviate a division of markets among financial institutions, and would that create a situation wherein we would avoid the possible necessity of coming back here 6 months later—after another radical shift?

Mr. CARSON. Mr. Weltner, I would say that that is a very excellent statement of my views—that your suggestion I think would go very far toward eliminating the type of problem that we are faced with today.

I would go one step further in saying that I believe that the whole spectrum of banking activities that are available to commercial banks today should be made available, either by statute or by regulation, to all financial institutions. This would have the effect—I think your question is, what would the effect be? The effect would be a heightened degree of competition between financial institutions, lowered costs of finance to borrowers, higher rates of return to savers and depositors.

At the same time, probably, a price squeeze on all kinds of financial institutions. It would be harder to make a dollar in this industry than it is today where we have a compartmentalization and regulation and protection of various kinds of institutions.

Mr. WELTNER. Do you feel that this would result in a substantial increase in competition among financial institutions?

Mr. CARSON. Yes, sir.

Mr. WELTNER. That is the best of all possible worlds, is it not, Dr. Carson, provided a fair return on investments can be made?

Mr. CARSON. Yes; I believe so.

Mr. WELTNER. I have noted over my rather short tenure in Congress that for a while banks would come in and say, "All we want to do is compete, but they will not let us compete." Over the last 6 months I have noted savings and loan associations coming in and say, "All we want to do is compete and we cannot compete."

They all ought to compete. I think it might be less than wisdom at this point to come in under these rather unusual market circumstances and direct the future of banking institutions by making territories.

As I understand, that is illegal under the Robinson-Patman Act.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Halpern?

Mr. HALPERN. Mr. Chairman, I would like to compliment the committee for bringing forth these three witnesses from the academic community. It should be obvious from their testimony that an effort has been made to bring before us some refreshingly candid testimony, regardless of the hazards usually associated with testimony casting doubt over the proposed legislation before our committee.

Would any of you distinguished gentlemen care to comment on the issuance of CD's this week in London, in an effort to secure Euro-dollars, and if this helps to finance U.S. corporate overseas subsidiary capital needs? Could this have an effect on our balance-of-payments program?

Mr. ROUSSEAS. I do not think I would have any comment—I would have to think that one over first.

Mr. HALPERN. I did not hear you.

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Mr. ROUSSEAS. I am not prepared to give an answer on it.

The CHAIRMAN. You want to know their effect on our balance of payments? I think it is a very interesting question.

Mr. HALPERN. Would you care to submit a statement to the committee?

Mr. ROUSSEAS. Yes.

The CHAIRMAN. Possibly each one of them would be willing to do that.

Mr. HALPERN. I directed my question to all three.

(Professor Rousseas submitted the following information:)

STATEMENT ON EURO-DOLLAR CERTIFICATES OF DEPOSIT BY STEPHEN W. ROUSSEAS AND ROBERT G. HAWKINS, PROFESSORS OF ECONOMICS, NEW YORK UNIVERSITY

The Euro-dollar Market involves transactions in U.S. dollar demand deposits held by foreign banks or foreign branches of U.S. banks. Generally, transactions in Euro-dollars involve the conversion of foreign held U.S. demand deposits into interest bearing time deposits in a foreign bank. In this respect they are similar, though with a difference, to the conversion of domestic demand deposits into domestic time deposits. The difference lies in the fact that Euro-dollar transactions do not of themselves alter the volume of demand deposits in U.S. banks and hence in the direct availability of U.S. bank reserves. Nevertheless, Euro-dollar transactions can lead to an increase in the income velocity of the U.S. money supply insofar as the transfer of title to U.S. dollar demand deposits involves, as is most likely, the activation of idle balances.

If, however, Eurobanks convert part of their Euro-dollars into local currency (assuming no conversion into gold), foreign central banks will hold the Euro-dollars as part of their international reserves with the foreign banks in a position to expand loans in terms of their own currency. In effect, this represents the monetization of dollar assets held by foreigners for local purposes. The foreign central banks, in turn, will invest their dollar holdings in U.S. treasury bills, CDs, unsecured bank notes and other New York money market instruments, thus contributing to the increase in the income velocity of money in the U.S.

Another facet of the Eurodollar market concerns the ability of money market banks, over the past few years, to borrow Eurodollars to meet Federal Reserve pressure on their reserves—at costs appreciably lower than those prevailing at the Fed's discount window or in the Federal Funds Market. This use of the Eurodollar market supplements commercial bank use of domestic CDs and unsecured bank notes to affect their reserve position. Eurodollars, like CDs, in other words, are a relatively new type of money market instrument allowing commercial banks to offset to some extent the monetary policies of the central bank—thus requiring, along with the dumping of treasury bills and the issuance of domestic CDs, an increasingly larger scale of open market operations on the part of the Federal Reserve in order to achieve predetermined policy goals.

With this very brief overview of the Eurodollar market, we would now like to address ourselves directly to Congressman Halpern's question concerning the balance of payments effect of the issuance of CDs in London by the First National City Bank of New York. The First National City Bank of New York issues Eurodollar CDs to foreign banks, corporations and individuals in denominations of $25,000 and up for a minimum maturity of 30 days and, as of June 15, 1966, at an interest rate three-sixteenths of a percentage point below the Eurodollar rate but four-sixteenths above the 5.5 percent regulation Q ceiling for domestic CDs on maturities of 3 months. The Eurodollar CDs, unlike the domestic variety, are not subject to regulation Q. The are, furthermore, not sold to U.S. citizens or corporations and are not redeemable in New York, though a secondary market was established for them in London.

From the domestic point of view, the action of the First National City Bank involves the conversion of foreign held demand deposits into foreign held time deposits; at the same time it enables the First National City Bank to compete for and to hold deposits and reserves. Since foreign holders of U.S. demand deposits are free to buy domestic CDs, this raises a rather interesting question: why has the First National City Bank of New York issued Eurodollar CDs?

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Before trying to answer this question, it should be kept in mind that the *official* deposits of foreign central banks and treasuries have been exempt from Regulation Q since October 15, 1962. Part of the explanation for the Eurodollar CDs must therefore be that the First National City Bank can now issue negotiable CDs to *non*-official holders of U.S. dollar deposits which are also not subject to Regulation Q.

The First National City Bank of New York thus finds itself in the position to compete for dollar deposits and thereby increase its ability to augment domestic loans. And it can do this without regard to Regulation Q, i.e., it can pay a return on Eurodollar CDs at more than 5.5 percent in the expectation that the return on its domestic loans, under present monetary conditions, will more than compensate it for this very high-cost money. This is, clearly, an avenue which is open only to the major U.S. commercial money market banks. It allows them to compete even more successfully, than in the case of domestic CDs, with smaller and medium-sized banks in the current scramble for deposits. And given the chronic U.S. balance of payments deficit (which continues to add to the supply of Eurodollars), the major New York and Chicago banks will be able to roll over their domestic CDs in the future without regard to a liquidity squeeze which could materialize if the treasury bill rate were to climb above the current domestic CD ceiling rates under Regulation Q.

From the balance of payments standpoint, certificates of deposits issued for Eurodollars have no direct impact. This is true whether the deficit is measured on the "overall (liquidity) basis" or on the "official settlements basis." In the former, increases in liabilities to *all* foreigners, both official and non-official, are a component of the deficit while the "official settlements" basis includes only the increase in liabilities to foreign official institutions. Increases in dollar liabilities to non-official foreigners are offset against U.S. capital outflows.

When an individual American bank issues a CD in the Eurodollar market, it acquires additional dollar reserves with a reduction in U.S. demand deposit liabilities to foreigners. The foreigner buyer, on the other hand, acquires a short-term claim on the CD issuer, thus increasing CD short-term liabilities to foreigners by an *equal* amount. Thus, since both transactions involve only non-official foreigners, the net balance of payments effect is nil under either concept of the balance. In effect, the U.S. banking system has exchanged foreign demand liabilities for short-term time liabilities.

While it is true that the sale of Eurodollar CDs has no effect on the balance of payments per se, there may be an indirect adverse affect if the issuing U.S. bank uses the reserves generated to relend to foreigners. *The Wall Street Journal* of June 15, 1966 reported that the First National City Bank of New York had this in mind when it undertook to issue Eurodollar CDs. If the First National City Bank of New York does indeed relend to foreigners, there will be a net capital outflow on the "overall (liquidity) basis" in the balance of payments, since liabilities to foreigners have increased through the CD sale while the demand deposit still remains in the hands of foreigners and the U.S. bank now has a claim on the foreign borrower. On the "official settlements" balance, however, the relending of the dollars abroad would have no impact since the claim on the foreign borrower and the deposit liability to the foreigner are offsetting. Thus, CD issues in the Eurodollar market have an adverse impact on the balance of payments *only* if the proceeds are relent abroad and *only* if the "overall liquidity" concept is used as the appropriate balance.

Other less concrete effects based on various contingencies could be examined but space does not allow this. However one possible indirect effect of issuing Eurodollar CDs could have a favorable impact on the balance of payments. This would arise if CDs are issued for Eurodollars which otherwise would have been sold by the European banks in the foreign exchange market and acquired by the Central Bank. Then, a non-official demand deposit liability would be transformed into an official short-term liability, and thus would worsen the "official settlements" balance but leave the overall balance unaffected. This contingency would tend to arise when a sizable U.S. payment deficit made Eurodollars plentiful simultaneously with tight credit conditions in the European money markets. If CDs could soak up the excess Eurodollars so as to forestall such sales of dollars, the balance-of-payments deterioration could be avoided. However, it is unlikely that such a confluence of factors would occur, and under normal circumstances the balance of payments would be neither helped nor hurt.

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The issues involved are highly complex and the emergence of Eurodollar CDs too recent to enable us to project with any accuracy their future development. We would like to recommend to the Committee on Banking and Currency that its staff undertake a comprehensive study of this matter. We append to this statement a copy of *Eurodollars: An Emerging International Money Market* written by Professor Ernest Bloch and issued by the Institute of Finance at New York University (see appendix, beginning on p. 679).

Mr. HALPERN. This just occurred yesterday. The question is, Would you care to comment on the issuance of CD's this week in London in an effort to secure Euro-dollars if this helps finance U.S. corporate overseas subsidiary capital needs—could this have a salutary effect on our balance-of-payments program? It could be adverse.

Mr. REES. Is this a dollar CD issued in London to raise money for U.S. plant expansion in Europe?

Mr. HALPERN. We are not sure.

Mr. REES. I deal somewhat in the Mexican market. We have several types of securities. One is a peso guarantee and another is a dollar guarantee. The dollar guarantee draws less interest, but your guarantee is considered by some to be stronger. Is the dollar CD a note that says that money will be paid in dollars by a bank in New York to a British investor who holds it?

Mr. HALPERN. No; as far as I understand, it is to raise dollars for U.S. bank loans.

Mr. CARSON. Who is issuing the CD? Is it an American branch bank in London or a British bank?

Mr. HALPERN. I believe it is an American branch bank. It could very well be Chase or First National City.

I would certainly appreciate your feelings on this.

Mr. Chairman, with your indulgence, I would like to ask each of these three economists a question that touches upon monetary policy. I think it is a very important question.

Would each of you comment or give your opinion as to whether or not you feel the Congress at this time should grant to the President standby controls over consumer credit as this committee recently recommended, keeping in mind the possible public misunderstanding of such action by the Congress?

Mr. CARSON. This would be in the domain of the Federal Reserve authority?

Mr. HALPERN. No, no; to the President.

Mr. CARSON. All right.

Mr. HALPERN. This committee has recommended that the President be granted standby controls over consumer credit.

Mr. CARSON. My own view is that consumer credit controls are unwise unless there is overwhelming need from the standpoint of preventing inflation or restraining excessive expenditures that are causing inflation.

I think it is far too early to impose such controls and I am a little skeptical about giving this power to the President unless the Congress is presently convinced that these controls are necessary.

Mr. ROUSSEAS. Mr. Halpern, I do not think consumer credit controls are required at the present time.

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If my memory serves me correctly, the Federal Reserve System once did have the power to regulate consumer credit and when the Federal Reserve was offered this power on a standby basis it refused it. I think if we are going to have standby controls on consumer credit it should be in the Federal Reserve System which has the primary responsibility for the control of credit.

Mr. HALPERN. I see there is disagreement there by the nod of the head.

Mr. CARSON. Absolute disagreement. We were being forthright a few minutes ago. I would like to simply mention that I wrote an article in a professional economics journal not long ago entitled, "Is the Federal Reserve System Really Necessary?" And while my conclusion was that the Federal Reserve monetary policy was necessary, that a great many activities of the Federal Reserve are both unnecessary and undesirable and I think I would agree with the chairman here that the President, if anybody, should have this power, since he has the responsibility.

The CHAIRMAN. Because he is elected by the people.

Mr. CARSON. Yes, sir.

(Professor Carson subsequently submitted the following articles for the record:)

[From the Journal of Finance, v. 20, September 1965, pp. 480–503]

COMMUNICATIONS

"IS THE FEDERAL RESERVE SYSTEM REALLY NECESSARY?": COMMENT

(Harmon H. Haymes *)

In the title of his recent article, "Is the Federal Reserve System Really Necessary?" (*Journal of Finance*, December 1964), Deane Carson raised a provocative question, but nowhere in his article did he answer it. The title asks if the Federal Reserve is necessary. The article does not deal with the necessity or even the desirability of the Federal Reserve. It merely suggests, with no analytical justification, two so-called "reforms" for the System: (1) that membership in the Federal Reserve be made voluntary for national banks as well as for state banks, and (2) that legal reserve requirements be abolished.

As a basis for his proposals, Mr. Carson describes a "mythology" which allegedly has developed. He offers no citations to indicate where or among whom the "mythology" exists. The first "myth" is the general belief "that member banks are necessary to the conduct of monetary policy." But this is not a myth. No one would argue that present membership arrangements constitute the only workable relationship, but some sort of coordination between the central bank and commercial banks is necessary if monetary policy is to function efficiently. At a later point in his essay, Mr. Carson presents his own proposal for monetary policy. His plan calls for "periodic reports to the Federal Reserve" from commercial banks indicating the amount of their cash and deposits. Some sort of formal relationship, whether it be called "membership" or something else, is necessary if such reports are to be required.

The second "myth" cited by Mr. Carson is the general belief "not only that legal reserve requirements are necessary to the conduct of monetary policy but also that these reserves have to be held at the central bank." The first portion of this "myth" has some foundation in fact. If legal reserve requirements are not necessary to the conduct of monetary policy, they certainly facilitate it. But changes in legal reserve requirements are not, as Mr. Carson asserts later, merely "a substitute for open market operations." The policy role is only one

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of the functions of legal reserves. They are also required for other reasons. If they were not, why would state governments, which do not engage in monetary policy, impose legal reserve requirements on the banks they regulate? Moreover, there are no laws in the United States requiring any commercial bank to hold any reserves with the central bank. Any Federal Reserve member bank may hold all of its reserves in cash if it so chooses. Deposits with Federal Reserve Banks are voluntary.

Mr. Carson's third "myth" is that Federal Reserve Banks perform useful functions not performed by private institutions, such as discounting, clearing of checks, and providing vaults for safekeeping of securities. But is there such a myth? The Federal Reserve does perform these functions, and on a large scale, but no one with even a passing acquaintance with American banking could fail to know that commercial banks also engage in all of these activities. In fact, the use of Federal Reserve facilities is entirely voluntary. Any bank, member or nonmember, may get these services performed by other commercial banks if it so chooses.

The last "myth" is that "the 261 directors of Federal Reserve Banks and their branches, the 12-man Open Market Committee, the 7-man Board, and the 12-man Federal Advisory Council somehow formulate a monetary policy superior to that which could be conjured up by a single governor. . . ." The idea that this "myth" exists hardly deserves comment. It is similar to suggesting that a single dictator could make all of the laws for the nation better than all of Congress together.

Mr. Carson's "reform" proposals bear directly on the first two "myths" only. They suggest no remedy for the implied uselessness of the Federal Reserve's service functions or for its allegedly unnecessary leadership. The first proposal, to make Federal Reserve membership voluntary for national banks, would according to his estimate raise the proportion of commercial bank assets outside the System to 31 per cent. His estimate is based on the assumption that national banks, if given a choice, would choose membership in the same proportion as state banks of about the same size. He states that "The effectiveness of monetary policy depends to some extent on the pervasiveness of its impact. . . ." but in the same pragaraph argues ". . . that the effectiveness of monetary policy with 68.5 per cent of commercial bank assets covered will be *no less* [emphasis supplied] than when 90 or 100 per cent coverage obtains." If the coverage can drop this much with *no loss* of effectiveness, why not a drop of twice as much? Or four times as much? Unless he can prove that there is a critical point somewhere below 68.5 per cent at which the loss of effectiveness begins, he has contradicted himself.

Mr. Carson advocates voluntary membership principally on the grounds that required membership forces small member banks to carry higher reserves than they otherwise would. He says they must maintain a legally required reserve plus deposits with correspondent banks in order to receive correspondent benefits. He then attempts to demonstrate the extent to which Federal Reserve membership imposes a discriminatory burden in his Table 3, which shows ". . . a consistent pattern of higher cash holdings to total assets for member banks than for nonmember banks." But Mr. Carson is a victim of the "*post hoc, ergo propter hoc*" fallacy. Table 3 does indeed show a higher percentage of cash holdings for member banks, but not necessarily for the reason he assumes. A more logical explanation is that member banks consistently hold more demand deposits than time deposits, and reserve requirements are much higher for demand deposits. For the banks in his sample the ratio of demand deposits to time deposits averaged 195 per cent at state-chartered member banks and 181.8 per cent at national banks, as compared with 123.4 per cent at nonmember banks. The table therefore provides no support for Mr. Carson's argument.

His proposal also suffers from the fact that national banks may at present withdraw from the Federal Reserve System at any time by switching from a federal to a state charter. He recognizes this in a footnote, but concludes that the tremendous loss of good will which would be incurred by dropping the term "national" from their names would be too costly to make it feasible.

Mr. Carson's second proposal is that legal reserve requirements for member banks be eliminated. His proposal is apparently based on the belief that the only reason for the existence of legal reserves is to carry out monetary policy, and that in the absence of legal requirements, commercial banks would voluntarily keep their reserves at some "desired" level specified by the Federal Reserve. Thus, according to Mr. Carson, all that would be necessary to assure the effectiveness of monetary policy would be a system in which all banks would report their re-

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serve levels, just as they do now to meet the legal requirements. Although the Federal Reserve has not used its ability to change reserve requirements as a tool of monetary policy to any great extent, the existence of legal reserve requirements is useful in that it assures the policy makers of some minimum level of reserves at member banks. A purely voluntary system would eliminate that assurance, although, according to Mr. Carson, "banks eschew borrowing as sin," therefore "loan and investment officers would keep an even sharper eye on the actual cash ratio than they now do on the free reserve position." (We would note in passing that since free reserves are excess reserves minus borrowings, an individual bank does not ordinarily have a free reserve position.)

Mr. Carson concedes that "the banks might well change their levels of desired cash reserves relative to deposits in a way that would counteract monetary policy," but, he says, " . . . precisely the same thing occurs with existing legal requirements." But it does not. The legal requirements place a floor under reserve holdings, averaged over the settlement period, and the fact that member bank reserves earn nothing tends to restrict their expansion.

If member banks should, as Mr. Carson suggests, keep reserves just as constant on a voluntary basis as on a required basis, it would be difficult to see any practical difference in the operation of the proposed system and the existing system. Perhaps a clue to Mr. Carson's antipathy toward legal reserve requirements may be found in his apparent subscription to a popular misconception. He asserts that reserve requirements "impose a tax on member banks that might well be levied in another way, if the revenue is needed or a need exists for penalizing a particular industry." But of course, legal reserves are not a tax. No one pays them; no one collects them. Instead, they are assets of commercial banks, and serve a useful purpose as a liquidity cushion in addition to their policy role.

As to the question of "revenue needed," we can only assume that Mr. Carson is misinformed. No one derives revenue from member bank reserves. The reserves may be held in their own vaults if the commercial banks so desire, and the Federal Reserve Banks have no need of member bank reserve deposits to enable them to acquire earning assets. In fact, they purchase securities in the Open Market by creating new reserves. (Not with Federal Reserve notes, as Mr. Carson assumes. The physical volume of notes involved would make Open Market operations unreasonably cumbersome.) And the creation of reserves is the objective of most such purchases.

Much of Mr. Carson's reasoning is difficult to follow, but perhaps his most baffling argument is that "Catering to the banks to induce them to retain membership diverts a good deal of the attention of our monetary authorities from the main business at hand. Voluntary membership would go far toward a solution to this problem." If the monetary authorities spend an inordinate amount of time trying to induce banks to retain membership when membership is *required*, why should they spend less time if membership were *voluntary?* Probably only Mr. Carson knows the answer.

Constructive criticism of any institution is always to be desired. It is unfortunate that Mr. Carson's criticisms are undocumented, and that his "reforms" are actually attacks on straw men of his own creation.

Federal Reserve Membership and Discrimination—A Comment*

(James W. Leonard†)

In a recent article in this *Journal* Professor Deane Carson presented an argument for the elimination of legal reserve requirements and for making membership in the Federal Reserve System voluntary. Carson's proposals are based upon an alleged discrimination factor. The purpose of this paper is to present a theoretical analysis which shows that the discrimination factor is not important, and then to give some empirical support to the theoretical argument.

The Carson Argument

The argument presented by Carson for voluntary membership in the Federal Reserve System is based upon the proposition that member banks, especially the smaller ones, are placed in a position of competitive disadvantage. This disadvantage arises from the fact that member banks are required to hold a larger

*Thanks are due Donald Hodgman and Carl Arlt for helpful comments.
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proportion of their assets in the form of cash. Member banks maintain balances with correspondent banks in order to obtain the services of the larger banks, and also must maintain legal reserves with the Federal Reserve Bank. The nonmember banks get double duty out of correspondent balances. Carson presents data which shows that nonmember banks have lower ratios of cash to total assets than member banks. Thus, the imposition of legal reserve requirements by the Federal Reserve tends to discriminate against member banks because they are forced to maintain a larger proportion of their assets in a nonearning form.

If the discrimination argument is to hold then it must be true that member banks are forced unnecessarily to sacrifice profitability for liquidity (or for correspondent services). The following analysis will show that no such sacrifice will be made.

The Counterargument[1]

We assume that member banks and nonmember banks are in an equilibrium position with respect to the amount of cash reserves, securities, and loans which they hold relative to deposits. The portfolios of each class of bank are assumed to be equally liquid. We assume that the Federal Reserve has decided to make additional reserves available to the banking system, and that these reserves are divided equally between the two classes of banks. Furthermore, we introduce the proposition that the member banks have decided to hold correspondent balances in exchange for the services which the larger banks provide.

After the Federal Reserve action the nonmember banks would still be in an equilibrium position. Reserves, securities, and loans would have risen sufficiently to maintain the same degree of portfolio liquidity as before. The member banks have used the additional reserves to establish correspondent balances. It seems logical to assume, however, that the member banks would also desire to maintain portfolio liquidity equal to the former equilibrium position. Reserves and deposit balances are more liquid than securities. Securities are more liquid than loans. Thus, the member banks are more liquid than the nonmember banks, and are more liquid than the original equilibrium position. This will cause the member banks to reduce the excess liquidity. This will be accomplished by decreasing securities and increasing loans.

After the reduction in securities and increase in loans, the portfolios of the member and nonmember banks will be equally liquid, even though the proportions of cash, securities, and loans differ. We could also expect the over-all rate of return to be the same. Therefore no sacrifice of profitability for liquidity has been made because of the decision to carry correspondent balances. Consequently the discrimination argument does not hold.

An Empirical Check

The ratios in Table 1 are presented as evidence of the validity of the previous analysis. An examination of the data in Table 1 tends to confirm the analysis. The member banks have compensated for their heavier cash position by reducing liquidity in the other two parts of their portfolio. There is no reason to believe that banks consider one portfolio to be any more liquid than the other two. The rates of return tend to substantiate this conclusion, and are also consistent with commonly accepted principles of profitability and liquidity.

TABLE 1.—*Selected ratios (in percentages) of National banks, State member banks, and nonmember banks*

[In percent]

	National banks	State member banks	Nonmember banks
1. Cash assets to total assets	17.58	18.41	12.75
2. Government securities to total assets	21.11	18.75	27.54
3. Loans to total assets	48.27	49.70	47.14
4. Net income to total assets	.74	.70	.68

Source: FDIC Annual Report, 1963.

[1] The approach of the argument is based upon a model presented by J. Aschheim in arguing the merits of open market operations versus reserve requirement changes. See J. Aschheim, "Open Market Operations Versus Reserve Requirement Variations," *Economic Journal*, December, 1959. Also, J. Aschheim, "Restrictive Open Market Operations Versus Reserve Requirement Increases: A Reformulation, *Economist Journal*, June, 1963.

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"Is the Federal Reserve System Really Necessary?": Comment

(George G. Kaufman*)

In a recent article in this *Journal*, Professor Carson questions "the need for a Federal Reserve *System* as it is presently constituted, quite apart from the generally acknowledged need for central bank monetary policy." Carson concludes that, in contrast with the existing complex structure, "a simple central banking structure is most conducive to successful monetary management, other things equal, and that we can reduce both its internal and external costs by adopting certain basic reforms." The two reforms discussed are voluntary bank membership in the Federal Reserve System and abolition of legal reserve requirements.

While these two frequently proposed reforms may be highly desirable on other grounds, I fail to see how they would either affect the structure of the Federal Reserve System or significantly reduce its costs. By removing the major "cost" of membership, the abolition of reserve requirements would permit a system of voluntary membership to be effective. However, as Carson correctly points out, banks would still have a demand for some cash reserves, at least part of which would be held in clearing accounts. In addition, most checks would continue to be cleared ultimately at regional Federal Reserve Banks or Branches. As a result, Federal Reserve employment and costs, which are functions not of the size of member bank reserve balances but of reserve activity, would be basically unaltered by the change. The relevant reform here, if a change in structure is to be the objective, is not the elimination of reserve requirements but of Federal Reserve check-clearing operations.

Likewise, wholly voluntary membership can be expected to accomplish little more than at most reducing the size of the bank relations departments of the various Reserve Banks.[1] Since these departments are small—for example, bank relations accounts for only about 10 of the almost 2,400 employees, or less than one-half of 1 per cent of total employment at the Chicago Federal Reserve Bank—any cost savings achieved can hardly be considered significant.

"Is the Federal Reserve System Really Necessary?": Reply

(Deane Carson*)

I

Harmon H. Haymes' comment on my proposals to abolish legal reserve requirements and make membership in the Federal Reserve System voluntary may be likened to the boxer who knowing he is losing on points in the final round and bleeding from cuts over the eyes, swings wildly in hopes of a knockout. Haymes not only fails to land a punch (with one exception noted below), but delivers himself several telling, and perhaps not altogether necessary, blows.

1. In defending legal reserve requirements, Haymes asserts that they "serve a useful purpose as a liquidity cushion in addition to their policy role." While such reserves may be used to meet adverse clearing balances over the reserve accounting period, and may fall below legal reserve requirements if counterbalanced by excess reserves and borrowings on the average, they are of extremely limited use as assets. Bankers generally consider *legally required reserve* balances as the most illiquid segment of their asset portfolio, useful over long periods only at a penalty rate of interest.

But why *legally* required reserve ratios are necessary to provide the sort of liquidity cushion that Haymes deems desirable is not stated. Banks will hold cash in vault to meet withdrawals and cash balances with correspondents to meet adverse clearings even if the Federal Reserve System did not exist. While there is a natural propensity for the regulator to assume that his ratios are superior to those that would be maintained voluntarily in the free market, such an assumption has no bearing on the function of cash as a source of liquidity. Indeed,

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[1] It may be noted in passing that the case for at least some compulsory membership is not that nonmembers per se represent a monetary slippage, as Carson indicates, but that member banks may threaten to withdraw if they disagree with System policy. Thus, the degree of slippage would vary with the posture of monetary policy and cannot be taken as an exogenous variable.

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without legal ratios is would appear that the "liquidity cushion" aspect of cash reserves would be enhanced.

2. We are left, then, with the "policy role" of reserve requirements. Haymes sheds no light on what this is and what mechanism is involved. Instead, he simply states that changes in reserve requirements and open marekt operations are not substitutes *because* the former play other (i.e., liquidity cushion) roles. This brings him full circle without making a dent in my position.

3. Haymes takes me to task for subscribing to a "popular misconception" that reserve requirements impose a tax on member banks for, as he puts it, "No one pays them; no one collects them." This is certainly a literal interpretation of what I meant by a tax; I trust that the theory of opportunity cost is not a popular misconception. Indeed, to the extent that legal reserve requirements are above the desired level of cash reserve to deposit ratios for commercial banks (and the evidence favors this assumption),[1] the legal ratio imposes a cost on member banks equal to the forgone revenues that would accrue had the unwanted margin of cash been invested.

4. In a curious parenthetical remark, Haymes ridicules my statement that the monetary authority *could* purchase securities by issuing Federal Reserve Notes, asserting that "the physical volumes of notes involved would make open market operations unreasonably cumbersome." I did not mean to suggest that payment be made in one-dollar bills. After all, how many zeros can a Federal Reserve Note contain?

5. On voluntary membership, Haymes attacks my position by declaring that "some sort of coordination between the central bank and commercial banks is necessary if monetary policy is to function efficiently." My observations are twofold: First, I do not understand Haymes' use of the word "cordination" except in the context of stimulus and response, which in any case operates through money and capital markets. What more is needed than my suggestion that commercial banks be required by law to report their balance sheets and other pertinent data to the monetary authority?

Secondly, one can reasonably infer from Haymes' defense of membership that it has contributed to the efficient functioning of monetary policy. What an indictment of the present System (and here I would include the elaborate superstructure of Federal Reserve officials) this is? Was the institutional arrangement responsible for such episodes as 1920–21, 1931, 1937, 1957, and 1960? If so, Haymes should be looking for alternatives.

6. Haymes states that my proposal for a simplified structure of monetary authority is tantamount to the belief that a dictator could make better laws than Congress. Here, he simply misses the point. Democratic procedures have much less to do with the number of people who are involved in decisions[2] than whether or not the people who make them are accountable to the public. The Federal Reserve System is structured to minimize accountability to the body politic and to its elected representatives, including the President of the United States.[3] This was accomplished by design, in order to insulate monetary policy from "political influence"; let us evaluate it on these grounds, rather than erroneously defending it as a means of democratically arriving at "good" monetary policy.

7. I am not, as Haymes asserts, involved in contradiction when I state that the effectiveness of monetary policy depends in part upon its pervasiveness and then assert that it would be no less effective with 68.5 per cent of commercial bank assets covered by membership than with 100 per cent. To answer his question, pervasiveness of impact has nothing to do with the percentage of assets covered; the 68.5 per cent was an estimate of what would obtain if membership were made voluntary for all banks. Haymes might well have objected to my theory of slippages and offered empirical evidence to refute it, but he remains silent on this crucial point.[4]

8. In my original article, I presented evidence to show that member banks tend to hold more cash relative to total deposits than nonmember banks (Table

[1] See my "Zero Reserve Requirements," *The National Banking Review*, September, 1965.

[2] If this were not the case, should we not double—or quadruple—the number of Congressmen and members of the Federal Reserve Board?

[3] On Federal Reserve "independence" see Chairman William McChesney Martin's statements in *Investigation of the Financial Conditions of the United States, Hearings*, Senate Finance Committee (Washington: GPO, 1957), Part 3, pp. 1361–63.

[4] My own investigation is not, as of the deadline for this reyly, complete. See *The National Banking Review*, op. cit. for a report of findings.

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3, p. 657). Haymes legitimately raises the point that this may be due to different deposit mix for member and nonmember banks. In my current empirical work I have included this variable, as well as several others, in the cash demand model.

Preliminary work on Illinois bank data reveals a strong tendency for member banks to have higher cash deposit ratios than nonmember banks, where the deposit mix is equal. From my two samples of 93 member and 94 nonmember Illinois banks, I have compared 58 pairs of banks, each pair of which had a virtually identical deposit mix. Forty-seven pairs (81 per cent of the total pairings) yielded nonmember banks with lower cash to total deposit ratios.[5] While this partially negates Haymes' criticism, other factors may account for the above results. Hopefully, the investigation of these factors will go far toward clarifying the controversy.

9. Haymes erroneously states that my proposal calls for commercial banks voluntarily to keep their cash reserves at a level *specified* by the Federal Reserve. How this interpretation emerged can only be surmised. What I did say was that individual banks would keep whatever cash ratios they desired and these would yield an aggregate ratio for the banking system. Then, should the Federal Reserve require such concepts as excess and free reserves in conducting monetary policy, it could assume a hypothetical desired (by the Federal Reserve) ratio, thus providing, through the difference in actual and desired cash, the indicator.

10. Haymes reminds me that banks do not *ordinarily* [italics mine] have a free reserve position. This is nit-picking. If I may pick my own nit, positive excess reserve minus zero borrowings equal free reserves; negative excess reserves minus zero borrowings equal negative free reserves, etc.

To conclude, far from having attacked straw men of my own creation, Haymes provides ample proof that the title of my article should be given serious consideration.

II

Professor Leonard's criticism of the membership discrimination hypothesis is based upon an analysis that is somewhat obscured by (1) his failure to define what he means by "liquid" and "liquidity," and (2) by questionable assertions such as "*reserves and deposit balances* are more liquid than securities," and "securities are more liquid than loans."

As for (2) above, it is not altogether certain that reserves and deposit balances *are* more liquid (whatever that means) than securities. For the most part, member bank reserve balances are highly sterile; this is also true of correspondent balances where the correspondent requires some minimum balance in return for services rendered. On the other hand, Treasury bills can be sold with one-day payment lag without significant loss to the seller.

Furthermore, some loans are more "liquid" than some securities, in the sense that they can be realized more rapidly and with smaller loss (demand loans vs. long-term governments, for example).

As for (1) above, the failure to provide an objective definition of liquidity makes it impossible to evaluate the statement "after the reduction in securities and increase in loans, the portfolios of the member and nonmember banks will be equally liquid, even though the proportions of cash, securities, and loans differ." Apparently the author has in mind an objective criterion of trade-off between cash (wherever held), securities (with various maturities), loans (of various quality), and rates of return. In any case, the model is not adequately specified.

Professor Leonard interprets his empirical findings as favorable to the nondiscrimination hypothesis. Without further analysis of such factors as deposit mix, size, and location, however, the differences he finds in net income cannot be attributed to membership status.

III

George Kaufman argues that cost-savings would be small if my proposals were adopted. He bases this contention on the grounds that there would be little reduction in the check-clearing function of the Federal Reserve, which accounts for a substantial amount of System employment and cost.

[5] Data from April 12, 1961 call reports. Illinois nonmember banks are not subject to any legal reserve requirement.

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At the present time, the Federal Reserve System (and ultimately, of course, the general taxpayer) subsidizes the clearing and collection of checks drawn on commercial banks. Kaufman suggests that significant cost reductions could be achieved through the elimination of this aspect of Federal Reserve operations.

The alternative to present arrangements (assuming the Federal Reserve went out of the check-clearing business) would be a private clearing system, either through large regional banks, or through new facilities established to meet the need that would arise. Assuming the former, clearinghouse banks would either explicitly bill users of this service or allocate costs by requiring minimum balances. In other words, the function of correspondent banks in this respect would simply expand; as a result of competition, regional clearinghouse banks would tend to emerge and specialize in this activity.

There is little reason to believe that this private system would be more efficient than the present one; it is generally recognized that check-clearing is efficiently handled in the Federal Reserve Banks and that a great deal of competition exists between District Banks to keep costs low. On the other hand, the reform proposal would allocate costs of clearing more directly to the users of checks rather than general taxpayers. In other words, social costs might well remain the same, although allocated in a different way.

This proposal would certainly alter the structure of the Federal Reserve System, and I am grateful to Kaufman for suggesting it. Together with my proposals, plus the currently strong Congressional demands to remove bank supervisory functions from the Federal Reserve System, we may some day have a central bank that is singularly devoted to monetary policy.

IV

If one is permitted to criticize one's own article, two points should be raised that my critics have generously ignored. First, Column 6 of Table 2 (p. 655 of the original article) should be captioned "column 4 times column 5" instead of "column 3 times column 4."

Secondly, it seems to me that my proposal to abolish reserve requirements could be attacked on welfare grounds: specifically, that it would tend to create an unearned capital gain for holders of bank stocks. As cash reserves were converted to earning assets, income would rise and therefore the capitalized value of the streams of income. Whether or not this bounty is defensible on any ground or whether or not it should be taxed away is properly the subject of another article.

Should Federal Reserve Float Be Abolished and Its Check Activities Curtailed?

(Irving Auerbach*)

Two articles have been published recently in which the Federal Reserve's role in check operations has been questioned. In one, Professors Brunner and Meltzer proposed that Federal Reserve float be abolished.[1] In the other, Deane Carson appeared to be recommending that the Federal Reserve's check clearing function be diminished, or at least that commercial bank correspondents be used more widely in clearing checks.[2] These issues were not the focal points of their respective articles. Neither are they as fundamental or controversial as the debates concerning the direction of monetary policy, the means of achieving a desired monetary goal, or the effectiveness of monetary policy. Nevertheless, they are sufficiently important to warrant critical examination, which is the purpose of this paper.

In order to provide some perspective, this paper will first briefly review the origins of the Federal Reserve's entry into check collection operations. Next, Part II discusses the rationale for the Federal Reserve's particular method of making payment to the accounts (largely member banks) presenting checks for

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[1] Karl Brunner and Allan Meltzer, "An Alternative Approach to the Monetary Mechanism." Subcommittee on Domestic Finance of the House Committee on Banking and Currency, U.S. Congress, August 17, 1964, pp. 91–92.

[2] Deane Carson, "Is the Federal Reserve System Really Necessary?," *Journal of Finance*, December 1964, pp. 652–661.

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collection. Part III presents the views of the critics of the present arrangements, with an analysis of the reasons for their objections. Finally, Part IV attempts to rebut these arguments.

I. ORIGINS

One of the prime reasons originally given for the adoption of the Federal Reserve System was to provide for a more efficient check collection system.[3] In fact, the Federal Reserve Act requires that: "Every Federal Reserve Bank shall receive on deposit at par from member banks or from Federal Reserve Banks checks and drafts drawn upon its depositors. . . ."[4] It also states that the Board of Governors may require each Reserve Bank "to exercise the function of a clearing house for its member banks."[5]

Prior to the establishment of the Reserve Banks' clearing arrangements,[6] the system for collecting intercity checks was highly chaotic and left much to be desired. The inherent difficulties stemmed from the large number of banks operating in the United States, the wide geographical distances that separated most offices from each other, and the absence of any unifying mechanism such as a national or regional clearing house for effecting direct exchanges of checks and payments. This situation made it necessary for the banks to rely on the network of correspondence relationships. Banks receiving out-of-town checks would transmit the items to a correspondent for collection, and payment would be received through a deposit credit on the books of the correspondent. If the correspondent did not have any contact with the drawee banks, the checks would be sent on to a correspondent of the second bank, and if the third bank was not the drawee bank or did not have a correspondent relationship with the latter, the transmission would continue until payment was finally made. Of course, the further the distance between the original collecting and drawee banks as well as each of their distances from a money center, the greater were the number of intermediaries (correspondents) that had to be used and the longer it took to complete the presentation-payment cycle.

Sound banking practices, as well as State Uniform Commercial Codes or Negotiable Instrument Acts, required (and still do) that checks be forwarded in the most direct and expeditious manner in the drawee banks.[7] Nevertheless, it was fairly common prior to the establishment of the Federal Reserve System for banks to route circuitously checks drawn on out-of-town banks.[8] There were a number of reasons for this practice. One was to avoid collection charges. Banks ordinarily charged other banks for the service provided in collecting checks. However, many banks had reciprocal agreements not to charge each other collection fees, or maintained a compensating deposit balance. Such banks would undoubtedly clear checks thorugh each other even though this clearance did not necessarily represent the most direct route for collecting the check. Another practice which abetted circuitous routing was non-par remittance by many banks for checks drawn by their own depositors. Banks receiving checks drawn on such institutions would attempt to find a collection route which avoided or minimized any losses in payment. A third factor was that some banks used checks deposited for collection specifically to build up balances at a correspondent bank. This method provided substantial savings over the alternatives—borrowings, purchase of exchange, or shipment of currency—and involved none of the risks associated with currency movements.

Circuitous routing was disquieting because, in augmenting the ordinary delays in collecting intercity checks, it increased substantially the opportunities for check kiting. Even more disturbing, it gave rise to sizable pyramiding of bank reserves. Correspondents passed credit for checks presented for collection by crediting immediately "due to banks." And, as a check went from one bank to

[3] Cf. H. P. Willis, *The Federal Reserve System* (New York: Ronald Press, 1923), pp. 145, 601, and 776–777; W. P. G. Harding, *The Formative Period of the Federal Reserve System* (Boston: Houghton Mifflin Co., 1925), pp. 51–52; and E. W. and D. I. Kemmerer, *The ABC of the Federal Reserve System*, 12th edition (New York: Harper & Bros., 1950), pp. 19–21.

[4] 12 U.S.C. 360.

[5] 12 U.S.C. 248(o).

[6] In this paper the terms clearing and collecting will be used synonymously, although technically they refer to different stages in the process of presenting checks for collection.

[7] Article 4, Section 204 of New York State's Uniform Commercial Code states that "A collecting bank must send items by reasonably prompt method. . . ."

[8] Examples of circuitous routing of checks may be found in W. E. Spahr, *The Clearing and Collection of Checks* (New York: The Bankers Publishing Co., 1926), pp. 105–107, and James G. Canon, *Clearing Houses* (U.S. National Monetary Commission, Senate Document No. 491, 61st Congress, 1910), pp. 70–72.

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another, it resulted in additional "due to" entries. Thus, for example, if a check had to be handled by four banks with two serving as intermediaries before payment was ultimately made, it was possible for bank reserves to increase by twice the amount of the check (see Table 1). If there were three intermediaries, there could have been a threefold expansion of bank reserves.

It made little difference whether these created balances were available immediately for withdrawal or not. For many banks they could be counted as part of the reserves maintained to cover their statutory reserve requirements and were included in such balances on the day that the checks were transmitted to the correspondent. For the remaining banks it can be readily presumed that balances due from banks could at least be considered as part of their desired reserve balances. Since these balances were indistinguishable from reserves obtained from more stable sources, they served as the basis for extension of credit. Their volatility, it is generally recognized, contributed to the monetary instability that existed before the establishment of the Federal Reserve System.[9]

TABLE 1.—*Example of multiple creation of reserves in collecting checks through correspondent banks*

Assume: (1) Payment between banks accomplished by debiting or crediting correspondent balance (due to or due from accounts)
(2) $100 check deposited with Bank A which is drawn on Bank D
(3) Bank A presents check to Bank B for collection
(4) Bank B in turn presents check to Bank C for collection
(5) Bank C holds balances due to Bank D and reduces these balances when it forwards check to Bank D

Bank A:	
Due from bank B	+100
Nonbank deposits	+100
Bank B:	
Due from bank C	+100
Due to bank A	+100
Bank C:	
Due to bank B	+100
Due to bank D	−100
Bank D:	
Due from bank C	−100
Nonbank deposits	−100
Net change for banking system:	
Due from banks	+100
Do	+100
Do	−100
Total	+100
Nonbank deposits	+100
Do	−100
Total	0
Due to banks	+100
Do	+100
Do	−100
Total	+100

On the surface, it might appear that those banks which could not count "due froms" as part of their statutory reserve balances (such as central reserve city banks or reserve city banks if the "due from" represented a balance with a non-central reserve city bank) would have had a reduction in their excess reserves, apart from any reserve losses arising from a withdrawal of bank balances. If this had been correct, the increase in "due to banks" would have

[9] Cf. Spahr, *op. cit.*, p. 109; Kemmerer, *op. cit.*, p. 20; Ray B. Westerfield, *Money Credit and Banking* (New York: Ronald Press Co., 1947), pp. 614–615; and Raymond P. Kent, *Money and Banking* (New York: Rinehart and Co., 1947), p. 214.

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raised their required reserves. However, this was not true. National banks and presumably many State banks were permitted (as they are today) to subtract balances due from domestic banks from their total deposits in computing reserve requirements.[10] Thus, the partial drag stemming from automatic increases in required reserves was not operative.

II. RATIONALE FOR FLOAT

Federal Reserve clearing of intercity checks has largely eradicated circuitous routing of checks and the delays associated with the earlier system. It has not, however, eliminated the creation of reserves associated with check operations, although the creation in proportion to the total volume of checks written is obviously considerably below the float credit that was outstanding before Federal Reserve clearings were established. Some of this creation stems from the continued use of correspondents to supplement the Federal Reserve's clearing operations and the expansion process is exactly as described above.[11] The remainder (Federal Reserve float) comes from the System's operations.

If there were to be no reserve creation in the Federal Reserve's check operations, payment for checks would have to be made on the same day that the drawee banks' reserve accounts are debited. However, due to the huge number of checks handled in one day and the wide geographical distances between collection points, no practical system existed at first and none exists at present (even with today's advanced electronic equipment and rapid air transportation) for achieving this objective. To achieve it would require that a separate record be kept of each check flowing through the Reserve Banks from the day it arrives until the final payment is made. It would also require a high speed transmission system capable of handling the millions of transfers that would have to be made each day.

Some impression of what would be required may be gleaned from the work load handled by the System in 1964. During that year the Reserve Banks processed about 19.5 million checks per day with a daily average value of more than $6 billion. Since it takes more than one day to complete the processing and payment cycle for many checks, the number of records that would have to be in an active file on any given day would, at last year's level of activity, be a number of times greater than 19.5 million. And the volume of check activity continues to expand yearly.

The initial Reserve Bank clearing arrangement provided for immediate and simultaneous debiting and crediting. However, this was a voluntary scheme and the facility was available only for clearing checks between those banks that had agreed to join the collection system. In addition, the plan did not extend to clearing checks between two banks that were members of the collection system but were located in different Reserve Districts. "On the face of the thing * * * the system could not work well and it required only about a year of experience to demonstrate this fact to the satisfaction of all." [12]

In place of the limited voluntary plan, in 1916 the Reserve Banks introduced a countrywide collection system and adopted a so-called "deferred-availability schedule" for making payment on checks presented for collection. Under this system banks submit checks sorted by deferred availability and possibly destination. Credit is passed automatically for all checks in each of these sorts on the day called for by the deferred-availability schedule. If all or some of the checks are not collected by the day payment is made automatically to the depositing bank, reserves (or float) are created. In any event, the procedure requires that the Reserve Banks maintain a record of only one bookkeeping entry covering a large number of checks (all the checks that are submitted by a bank in one sort) in place of a list for each check in the sort

For many years, the payment lags in the deferred-availability time schedule were close to the actual number of days it took to deliver and collect checks. Nevertheless, float developed largely because of unavoidable processing delays

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[10] See U.S. Comptroller of the Currency, *Annual Report for 1913* (Washington: Gov't. Printing Office, 1914), p. 8; and Allan A. Young, *An Analysis of Bank Statistics for the United States* (Cambridge: Harvard University Press, 1928), p. 1.

[11] Banks that are not members of the Federal Reserve System must use correspondents to clear checks unless they maintain a nonmember clearing account with a Reserve Bank. Many member banks continue to use correspondents for reasons that will be discussed later, but virtually all out-of-town checks eventually clear through the Reserve Banks unless they are non-par items.

[12] Willis, *op. cit.*, p. 1060.

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and transportation difficulties. Moreover, it was not practicable to develop a schedule which conformed to the actual collection time for every last hamlet in the United States. The first schedule at some Reserve offices had a maximum deferment of 9 calendar days, but this was soon changed to 8 calendar days. With the introduction of air shipments, delivery times were speeded up and the availability deferments were reduced in 1939 to a maximum of 3 business days. The maximum deferment was reduced to 2 business days in January 1951, and this maximum is in effect today. The adoption of this maximum represented the first major departure from the principle that the payments schedule should match closely the actual collection time. This change has resulted in one day's float arising automatically for all checks deposited in a bank in one Federal Reserve territory that are drawn on banks located in other Federal Reserve territories in areas that are not in the immediate vicinity of a Reserve Bank or branch office.

One apparent reason for the 1951 change was the Federal Reserve's desire to reduce the number of sorts that have to be made by the banks in presenting checks for collection. An even more important reason may have been a desire to increase the incentive for banks to join or remain in the Reserve System. Banks that use correspondent banks for clearing checks continue to receive immediate credit for all checks presented for collection, and a bank considering joining or leaving the System no doubt weighs this benefit against the Reserve Bank's procedures. Receipt of immediate credit as opposed to delays of as much as 2 business days induces a large number even of member banks to clear out-of-town checks through a correspondent bank rather than the Federal Reserve.

While a member bank cannot count balances with other banks as part of its statutory reserves, the immediate credits, as mentioned earlier, can at least be considered as part of its desired reserve balances and perhaps release collected funds to meet statutory needs. Also, while the collecting bank ordinarily does not allow the balances to be withdrawn until they become collected funds, it is believed that the uncollected balances are counted as part of the minimum balance needed to be maintained to compensate the bank for the services provided to the correspondent.[13] If the bank is a nonmember, it is likely that it can count all of its balances with an approved depositary as part of its statutory reserves. Furthermore, it is important to remember that since the collecting bank does not permit the depositing bank to withdraw the proceeds until the funds are collected, the former can provide immediate credit without incurring any direct cost. Banks are still permitted to reduce their deposits by the amount of any uncollected checks in computing reserve requirements.[14]

III. CRITICISMS

A. *Brunner and Meltzer*

In their study prepared for the House Banking and Currency Committee, Professors Bruner and Meltzer recommend that Federal Reserve float be abolished. Their stated objective is to eliminate Federal Reserve defensive open market operations—the purchase and sale of Government securities to offset seasonal fluctuations in bank reserves. They claim that a "major reason used to justify defensive open-market operations is the existence of float."[15]

Brunner and Meltzer's particular concern with discontinuing defensive open market operations is their belief that the primary if not sole purpose of Federal Reserve policy should be "controlling the movements of the stock of money." They argue that: "The operations designed to smooth the reserve adjustments for banks, the day-to-day operations that often dominate System policy, introduce a large amount of variation in the monetary base. As a result, such operations add to the variation of the money stock, weaken or reduce the 'degree of control' over the money supply, and introduce substantial changes in the monthly rate of change of the money stock."[16] While they have not been the first to decry

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[13] It should be noted that with the availability of computers, banks are making more detailed cost analyses of the services provided to their depositors. As a result, some banks are now requiring their correspondents to keep higher compensating balances to allow for the portion of the maintained deposit that represents uncollected funds.

[14] Despite the difference in terminology, this procedure is the same as the one described earlier. For reserve computation and other purposes, uncollected checks are synonymous with balances due from banks.

[15] *Op. cit.*, p. 91.

[16] *Ibid.*, p. 79.

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Federal Reserve defensive open market operations,[17] they are the first to argue that abolishing float would largely remove the need for such operations.[18]

Brunner and Meltzer do not adequate indicate what they are suggesting as an alternative to the present arrangements; indeed, they appear to be presenting opposing alternatives. At one point they state that they would replace "the predetermined guaranteed collection schedule with the actual collection schedude." [19] This suggests that the Federal Reserve would continue to be used for out-of-town check collections and the banks would receive credit on the same day that payment is received from the drawee banks, so that there would be no float at all.

And yet, on the next page, this paragraph appears:

"Sizable intramonthly variation in reserves would occur because of the intramonth variation in the volume of checks drawn. We suggest, that bankers be permitted to solve this problem on their own, without Federal Reserve interference, by anticipating reserve drains in advance, by purchasing or selling Federal funds, or by borrowing at a penalty rate from the Reserve banks. We are pleased to note that some bankers partially share our view that bankers would be able to solve some of these problems, without Federal Reserve assistance, under alternative institutional arrangements."

The opening sentence of this paragraph, given their already stated objections to float, suggests that they prefer banks receiving credit after payment is made by the drawee banks. Presumably, while some portion of the corresponding debits and credits would take place on the same day, a large volume would occur with some lag depending upon geographical distances, processing lags, and communication arrangements. Otherwise, how could there be any variation of reserves at the same time that the Federal Reserve is not extending float? If this interpretation is correct, then the procedure would give rise to a permanent but widely fluctuating volume of credit float (as opposed to the normal debit float that exists under present operations).[20]

The substitute proposed by Brunner and Meltzer is made more obscure by the last statement of the quoted paragraph. This remark appears to imply that some alternative arrangements should be adopted to replace the Reserve Banks in clearing and collecting checks. However, it can also be interpreted to mean that the alternative institutional arrangements refer to Federal funds transactions and borrowing at a penalty rate from the Reserve Banks, rather than the replacement of the Federal Reserve's clearing arrangements with a privately-run system.

B. Deane Carson

Professor Carson argues that membership in the Federal Reserve System should be on a voluntary basis and that there should be no statutory required reserves. In his opinion banks should be free to choose "between public and private suppliers of banking services to banks." He states that "large private banks, as correspondents, now provide a very wide range of such services on terms that are clearly superior to similar services provided by the Federal Reserve Banks."[21] Since many banks find it more desirable to use these private services, he argues, those that are members are unduly burdened because they must maintain an adequate balance with the correspondent as compensation for the services received as well as the reserve balances required by Federal Reserve regulations. (Data are presented to show that member banks maintain larger primary reserves than nonmember banks.) Thus, to eliminate discrimination, he recommends that compulsory membership in the System be abolished.

One of the services which Carson says can be provided more efficiently by private banks is check clearing. He does not expand on this view. Thus, it is difficult to determine whether he believes that correspondent check clearing serves as an alternative to the Federal Reserve for collecting out-of-town items, or

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[17] Albert H. Cox and Ralph F. Leach, in "Defensive Open Market Operations and the Reserve Settlement Periods of Member Banks," *Journal of Finance*, March 1964, argue for the same objective. They believe that the operations are an unnecessary and unwarranted interference in the money market.

[18] They state on page 91 that: "This [the abolition of float] would eliminate the rationale for many of the defensive open-market operations required to adjust for changes in float."

[19] *Ibid.*, p. 91.

[20] All unqualified references to float in this paper refer to debit float.

[21] *Op. cit.*, p. 656.

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whether it supplements the latter and is really part of the same clearing arrangement. However, since he claims that correspondent banks provide check clearing services more efficiently than the Federal Reserve, there is a strong implication that he has an impression that the former is true. Therefore, it is probable that he would argue for curtailing the Federal Reserve's check activities, or maybe their abandonment. In any event, he is at least recommending that correspondent relationships be used more extensively for clearing checks.

IV. REBUTTAL

A. Brunner and Meltzer

1. *Massive increase in equipment and work force.* Part of the reply to Bruanner and Meltzers criticism has been provided above in the discussion of the rationable for float. As indicated earlier an arrangement whereby payments are made for checks presented for collection on the same day that remittances are received from drawee banks, so that all Federal Reserve float is eliminated, would result in a massive increase in space requirements, advanced electronic equipment, and work force at the Reserve Banks.

No estimates are available that would indicate the scope of the increase in manpower and equipment needed to adopt simultaneous processing of check receipts and payments. However, an impression of the increased needs may be obtained from a study made in 1938. At that time, it was calculated that the Federal Reserve Bank of Philadelphia would have required a force of 6,684 employees against an actual staff of 288 at the Bank to have handled checks on a collection basis rather than the automatic, deferred-credit arrangement.[22] Of course, the availability of electronic equipment today makes it difficult to use these figures as a reliable guide for judging what would be needed at the present time to switch to a collection basis. But the magnitude of the task can be appreciated when one recognizes that under the present system the Reserve Banks have to post on average perhaps no more than 5 totals per day for each bank that clears through the Reserve System.[23] To eliminate float, the Federal Reserve Banks would, at 1964's level of activity, have to record on average each day 19.5 million totals and supporting information, be able to retrieve the records when notification is received that remittance was made by the drawee banks, and make 39 million debit and credit entries to reserve accounts.[24]

2. *Exaggerate seasonal reserve swings.* Another aspect of Brunner and Meltzer's proposal which is not valid is that eliminating float would reduce the need for System defensive open market operations. Actually, such a development would increase the seasonal swings in reserve needs. Admittedly, float has wide seasonal fluctuations. However, currency outside banks [25] and required reserves each at times accounts for as much change in the supply of reserves as float, and the combined seasonal changes of these two factors always exceed the fluctuations in float during January (see Chart).

It will be noticed that the largest change in float occurs between the end of December and the beginning of February, when a reduction in the amount outstanding absorbs almost $1.6 billion of reserves. Currency and required reserves tend to experience their maximum seasonal movements in the same period, when they normally *supply* nearly $2.0 billion of reserves. The changes in November and December are also very large for all of these factors: float expands by $1.4 billion and currency outside banks and required reserves increase by about $1.3 billion. In both periods, in other words, the changes in float tend to *modify* the reserve impact of the other two factors. Thus, the elimination of float would increase the seasonal swings in bank reserves over the year and the need for defensive open market operations. Brunner and Meltzer could not

[22] Wallace M. Catanach, "Check Collections" (Unpublished Stonier Graduate School of Banking Thesis, June 1939), p. 31.

[23] Postings depend upon the number of sorted bundles presented for collection. Banks have to make no more than 3 sorts in submitting checks to the Federal Reserve Banks. However, some of the larger banks, if they are located in the same city as their Reserve office, submit checks throughout the day and would have more than 3 entries per day in their deferred availability accounts. This would also be true for banks that send checks directly to other Reserve Banks for collection and only notify their Reserve Banks of the dollar amounts of the checks transmitted for collection.

[24] In passing it may be noted that, if it were feasible to develop a system which would eliminate float and the System were to assume the cost, reserves equal to at least the average level of float would have to be supplied to the banking system through some other means—for example, through open market operations or changes in reserve requirements—if there were to be no reduction in the availability of bank credit.

[25] Represents currency in circulation less member bank vault cash.

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go a step further and recommend that changes in currency outside banks and required reserves be abolished, because the System has no direct control over the movements in these factors.

3. *Float would still have wide unpredictable swings even with adoption of a more realistic time schedule.* As mentioned earlier, it is not clear what Brunner and Meltzer are suggesting in place of the current payments system. It may be that what they intend to recommend is that the System adopt a deferred availability schedule that conforms more closely with the actual collection times. This approach would reduce both the size and variation of float, but the amount that would remain would still be large. No current data are available to indicate what this remainder might be. But in New York, which accounts for over 25 per cent of System float, time-schedule float represents no more than 50 per cent of the District's total.[26] Furthermore, fluctuations in holdover and delays-in-transit float tend to be more volatile and unpredictable than time-schedule float. Thus, it is doubtful whether the adoption of a more "realistic" time schedule would satisfy Brunner and Meltzer's stated objective—the removal of a factor contributing to the need for defensive open market operations.

B. Deane Carson

1. *Misleading implication.* The principal criticism that can be made of Deane Carson's views concerning the System's check operations refers to his implication that correspondents provide a clearing arrangement superior to that offered by the Federal Reserve. While less than 43 per cent of the member banks clear out-of-town checks directly through their Federal Reserve offices, the clearance for all but a nominal number of out-of-town checks is arranged through the Reserve System. In other words, the city banks turn to the Federal Reserve to clear all checks received from their correspondents that are drawn on out-of-town banks except those that are non-par items.

What makes clearing out-of-town checks through city correspondents so attractive to many banks is the practice described earlier of giving immediate credit for all items presented for collection. It will be recalled that while these balances may not be available until they become collected funds, certain advantages accrue. For member banks they at least may be considered as part of total desired reserves, and for many nonmember banks they may be used to cover reserve requirements. Also, for both classes of banks such balances may be counted toward the minimum balance required as compensation for the correspondent services received. Moreover, there is no reserve loss to the city banks because they are still permitted to offset the increase in deposits by the amount of any funds in the process of collection.

Another advantage in using correspondent banks to clear checks is that they generally permit all items to be submitted in one bundle, rather than sorted as required by the Reserve Banks. However, this factor is not as important as the ability to receive immediate credit for all items. Making a three-way sort could not possibly add so much to a bank's workload that it would be induced to use a correspondent bank rather than a Reserve Bank to clear out-of-town checks solely to avoid the sort.

2. *Need for unified payments mechanism.* One cannot take too seriously the possible implication that the Federal Reserve's role in clearing checks should be abandoned. Surely, as a minimum the Reserve Banks should continue to be used to effect payment for check clearings. Any other conceivable arrangement would be impracticable and would add considerably to the amount of reserve pyramiding that takes place under present procedures.

3. *Increased multiple handling of checks.* Even if the purport of Carson's proposal is only a reduction in the extent to which banks use the Federal Reserve directly to clear checks, his views in this area are open to criticism. The greater the use of correspondents to clear out-of-town checks, the greater the multiple handling of checks. Not only is this uneconomic from the point of view of costs, but it undoubtedly conflicts with the requirements of the Uniform Commercial Code for a "reasonably prompt collection method" as long as a more direct system—through the Reserve Banks—is available.

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[26] Float consists of three elements: (1) Time schedule—float that arises because even under the most favorable circumstances checks could not be collected within the time prescribed for payment to be made under the deferred availability schedule. (2) Holdover—float generated by the inability of the Reserve Bank's staffs to process all checks on the day of arrival because of work overloads. (3) Delays in transit—float resulting from failures of checks to be delivered on time owing to inclement weather grounding airplanes, floods disrupting rail traffic, labor strikes, etc.

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C. Conclusion

The best that can be said for Brunner and Meltzer's proposal to abolish float, and Deane Carson's implied suggestion to curtail the System's check clearing operations, is that these aspects of their discussions are not crucial to their major considerations. Obviously, they did not give adequate attention to the implications of their respective proposals. This is especially evident in the contradictory statements Brunner and Meltzer make concerning their suggestion. One cannot argue for a check payments system in which credits and debits are made simultaneously, and then state that there would be sizable intramonthly fluctuations in bank reserves owing to variations in the volume of checks written.

It is hoped that this article has indicated the economies and efficiencies of present check clearing arrangements, and the desirability of retaining the existing system. Even if it were desirable to abolish float, this move in itself would not be sufficient to achieve Brunner and Meltzer's ultimate objective—the abandonment of defensive open market operations. In fact, it would increase the need for them, since the intrayearly float movements partially offset the seasonal changes in currency outside banks and required reserves when the movements in these factors are at their peak amounts. And Carson has unfortunately failed to consider that, while banks may obtain "better" check clearing services from their correspondents than from the Federal Reserve, because they receive immediate credit for all items and do not have to sort, correspondent clearing increases the costs and delays of check processing.

AUERBACH'S DEFENSE OF DEFENSIVE OPERATIONS

(Karl Brunner† and Allan H. Meltzer‡)

Irving Auerbach's paper reviews the history of check collection procedures and recalls the important contribution that the Federal Reserve has made by improving the cleaning process and by spreading par collection. It is easy to underestimate the powerful influence of improvements in the check-clearing methods on the spread of deposit banking, or the influence of the Federal Reserve System in reducing the time required for collection and their contributions to the advance of collection technology. We are inclined to interpret his opening section in this way, rather than as a suggestion that the former slow and circuitous collection system would return if the Federal Reserve were to follow our recommendation and abolish float. The costs and returns arising from the various collection methods were not discussed in our report, and our recommendation was not intended to suggest that the Federal Reserve eliminate its check-collection service.

Much of our report was critical of so-called "defensive open market operations." One reason—a major reason, we said—for defensive operations was to offset variations in the difference between "uncollected items" and "deferred availability credit" that give rise to variations in the interest-free loan called "float." Float is an important source of short-run changes in the monetary base and an important source of short-term variations in bank reserve positions, as Auerbach's chart suggests.

Our proposal may be more costly than present procedures. We suggested that it would have a benefit as well, by eliminating one of the reasons for defensive open market operations. Auerbach minimizes and even denies the possibility of benefits, and magnifies the costs. Although his argument is not sufficiently development to be convincing, he may be quite right in his judgments about the costs and benefits of the proposal. Four considerations make us quite hesitant to accept his conclusion, however. Two points are of importance only because they indicate the ways in which Auerbach has understated the benefits and overstated the costs. The other two suggest that the main difference between us is a much more fundamental difference in our approaches to the monentary mechanism. The minor points will be disposed of first.

THE MINOR ISSUES

If a "massive increase in equipment and work forces" would be required to keep 39 million records so that the drawee and the drawer bank could be debited

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and credited on the same day, the cost of abolishing float may be prohibitive. The most rudimentary knowledge of double entry bookkeeping suffices to dispose of this point. All that is required is a centralized debit-credit matrix for the banking system. The sorting of checks by drawer's bank would have to be supplemented by a secondary sort by drawee's bank. The net change in reserve position, the daily accumulation of credits and debits for each bank, would be posted to the reserve accounts. Many banks now use magnetic ink. Electronic processing of the information through a system of linked computers does not seem prohibitively expensive.

Auerbach's contention that we overstated the benefits is based on his argument that the movements of currency and required reserves partially offset the impact of float on reserve positions. This argument may be correct, although Auerbach's evidence in support of it is frankly puzzling. We are aware that float and currency have similar seasonal patterns. Float and defensive operations designed to reduce the impact of float on reserve positions are of significance because they introduce sizable *daily* and *weekly* variation in the monetary base. Auerbach's discussion of cumulated seasonal movements has no bearing on this point, and his chart supports our statement that attempts to offset variations in float introduce variations in the monetary base. Required reserves plus currency is a close approximation to the base for the postwar period.

THE MAJOR ISSUE

Our dispute with Auerbach is not about these relatively minor points but about related though much more fundamental differences. One difference is suggested by his statement that abolishing float "would increase the seasonal swings in reserve *needs*." [1] The other is his use of free reserves as the indicator of the effect of float, currency movements, and required reserves on the banking system. These points are so closely related that they are considered together. Both reflect Auerbach's acceptance of a theory of the monetary process that we do not accept. If we shared a common theory, it is quite likely that Auerbach would be more willing to accept our conclusion about defensive operations and float.

Auerbach's statement about reserve needs and his use of free reserves as an indicator reflects the Federal Reserve's traditional approach to the monetary mechanism. A major point in our report was that this approach, though not accepted by all Federal Reserve officials, is the dominant approach and has held a pre-eminent position within the System. We attemped to make clear that the use of free reserves as an indicator is unwarranted even if the relation of free reserves to changes in bank credit or interest rates is taken as the basic equation of the monetary mechanism.

Moreover, our report dwelt at length on the fact that no theory had ever been developed, no evidence has ever been presented, and no coherent, fully articulated argument had ever been made that implied (or even suggested) that the elimination of *weekly* or *daily* movements in free reserves had much bearing on the accomplishment of the principal tasks that Congress entrusted to the Federal Reserve. The evidence presented in our report seems to suggest, on the contrary, that concern with daily or weekly movements in free reserves is a severe impediment to the attainment of the policy goals embodied in the Employment Act. It is somewhat discouraging to find that Auerbach overlooks our analysis and evidence in his defense of defensive operations.

The difference between us can be stated in simple terms. Auerbach takes for granted that float and other money market changes must be offset by the Federal Reserve. This is clearly indicated by his repeated statement that our proposal to eliminate float would increase the "need for defensive operations." He provides no argument to show that the elimination of daily, weekly, or seasonal changes in a few interest rates—the purpose of defensive operations—is an important means of achieving price stability and a higher level of employment and is not in conflict with those goals.

His assumption may be correct. It may be more important for the Federal Reserve to reduce fluctuations in money market rates by introducing fluctuations in the monetary base and the money supply, than to provide a more stable growth rate of the money supply. However, adherents of the Federal Reserve's approach have never articulated the case for defensive operations. Like Auerbach, they have assumed that defensive operations are "needed."

[1] Italics added.

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A FINAL POINT

It is difficult to understand why Auerbach believes there is a conflict between the recommendation that float be abolished by making simultaneous debits and credits to reserve accounts, and the statement "sizable intramonthly variations in reserves would occur because of the intramonth variation in the volume of checks drawn." He notes that intramonth variations in the reserve positions of individual banks occur for reasons other than the movement of float. The intramonthly redistribution of reserves that accompanies the redistribution of deposits is not inconsequential. Our proposals XI to XIV on the four pages preceding the discussion of float were suggestions for dealing with other short-term movements without recourse to defensive operations. The paragraph from which Auerbach quotes was intended to recognize that elimination of float was part of a more extensive proposal for dealing with the daily, weekly, and monthly movements that seem to furnish the main justification for the Federal Reserve's attachment to free reserves. We are grateful to Auerbach for pointing out the possible misinterpretation and will attempt to correct it in the revised and extended version of the report that will appear in the near future.[2]

"SHOULD FEDERAL RESERVE FLOAT BE ABOLISHED AND ITS CHECK ACTIVITIES CURTAILED?": REPLY

(Deane Carson*)

Irving Auerbach is correct in stating that the check-clearing implications of my proposals to abolish reserve requirements and place membership in the Federal Reserve on a voluntary basis were not focal to the arguments of my article. Indeed, I am not an expert on the economics of check-clearing and, in any case, only mentioned in passing in my article the fact that most small national banks do not clear through the Federal Reserve Banks directly, even though they are required to be members and maintain legal reserves.

In brief, it is obvious that my proposals could be adopted without the least interference with present arrangements for clearing checks: large banks would continue to clear their own and their correspondents checks through the Federal Reserve Banks, maintaining whatever minimum clearing balances that would be necessary to accomplish the task.

I consider it an interesting commentary on the state of the central banking art that, of the three comments from Federal Reserve economists, not one seriously discusses, let alone challenges, the implications of zero reserve requirements for monetary control, which was the focal point of my original article in the December issue.

Mr. ROUSSEAS. I do not think Dr. Carson and I are in total disagreement because if you remember correctly, the Federal Reserve as I would like to see it would be part of the Department of Economic Affairs which would be in the executive branch of the Government under the control of the President.

The CHAIRMAN. Would be a part of the executive branch?

Mr. ROUSSEAS. Yes.

Mr. KLEBANER. I could never understand why the Board of Governors in an unusual act of self-abnegation turned down the possibility of standby controls some dozen years ago after a study was made on the subject.

I think that the standby authority can certainly do no harm. It is intended for use only under very exceptional conditions and merely takes cognizance of the fact that certain actions may be needed at a time when the Congress is not in session and saves the trouble involved in calling a special session.

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[2] *An Analysis of Federal Reserve Monetary Policymaking* (Chicago: University of Chicago Press, forthcoming).

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I for one therefore would be very much in favor of standby consumer credit controls. I think that the authority should be lodged in the body which is responsible for monetary policy, thus far the Federal Reserve.

Mr. HALPERN. Has consumer credit increased abnormally?

Mr. KLEBANER. I do not have any series of figures in my mind at this point. My impression is that it has of course reached an alltime high, but that happens almost every month. I would not say that it is in any sense unusual. I would suspect the situation in 1955 was much more so.

Mr. HALPERN. Mr. Chairman, my time is up.

I would like to, if I may, ask one question of Mr. Rousseas.

You said that the Federal Reserve System has lost the initiative in monetary policy. With this I agree in large measure. Would you care to elaborate briefly?

Mr. ROUSSEAS. Yes; this also is a part of my statement which I did not go into in my oral presentation and this has to do with regulation Q.

You will recall that regulation Q has been revised upward in each of the last 4 years and it seems to me that the December 6, 1965, revision of regulation Q was virtually forced upon the Federal Reserve by virtue of the liquidity squeeze the commercial banks had found themselves in.

As we know, corporations by and large hold negotiable CD's. They hold them for quarterly dividend payments and tax payments. Consequently, the average maturity of these CD's—I have the figures in my statement—was rather low, and if the commercial banks were not permitted to roll them over they would have been in serious trouble. I should also point out that the 6-month Treasury bill rate had gone above the CD rate—thus creating the serious problem for the banks in rolling over their maturing CD's. In effect the Fed's hand was forced in increasing the regulation Q ceilings. And again, which brings me back to my concern with the average rate of turnover of the money supply, there was a softening of the impact of monetary control by the Federal Reserve System.

Mr. HALPERN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Gettys.

Mr. GETTYS. Dr. Carson, I wonder if you or the staff could make available to us a copy of your article on "Is the Federal Reserve Necessary?"

Mr. CARSON. Yes, sir. I believe it appeared in the Congressional Record, inserted by the Congressman from Rhode Island.

Mr. GETTYS. Then I would like, Mr. Chairman, to ask the staff to get the citation in the Congressional Record so that I can have the pleasure of reading that article.

As I understand, Dr. Carson, you and Mr. Rousseas both feel—I do not think Mr. Klebaner expressed his opinion while I was in the room—that the Federal Reserve should be more responsive to political considerations; is that correct? Is the impression I got from each of you correct?

Mr. CARSON. That I think is a blunt way of putting it.

Mr. GETTYS. Would that not be the sum total of it?

Mr. CARSON. In effect that is the view that I would take, that monetary control should be exercised and executed by responsible public

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officials elected by the people of the United States. In effect this is simply saying that power and responsibility ought to go together and that is not, I think, presently true in the Federal Reserve System.

Mr. GETTYS. Does not the Executive have eventual control of the policies of the Federal Reserve?

Mr. CARSON. Yes; eventually in terms of perhaps 14 or 27 years.

Mr. GETTYS. And precipitous action on the part of politicians—sometimes it would not be good for the country, would it, if you just change policy overnight without consideration of other factors involved?

Mr. CARSON. I agree, sir, but there might be cases in which political influence would lead to improper results.

Mr. GETTYS. Would it not destroy stability?

Mr. CARSON. I would point out the experience of 1929 to 1933 as an example of what can happen when the responsibility and the power are separate.

Mr. GETTYS. My time is running. Thank you.

Mr. ROUSSEAS. May I comment on this?

Monetary policy was not a very serious policy instrument during the 1930's, for obvious reasons, and during the war with the average Government interest rate pegged at roughly 2 percent. So if we talked about the independence of the Federal Reserve from 1930 to 1951, who cared about it? It was not an important policy instrument. Since 1951, during the Eisenhower administration, a great deal of stress has been put on monetary policy over and above fiscal policy.

Mr. GETTYS. And it is today; is it not?

Mr. ROUSSEAS. Yes. My view is: when you increase responsibility for, in a democratic society, you must simultaneously increase responsibility to. You cannot separate them. As long as responsibility for economic policy did not lie with the Federal Reserve, the Fed's independence was not an issue. I continue to maintain that the independence of the Federal Reserve must be thought of in two ways, really three ways: Independence from the Congress, independence from the Congress for appropriation purposes, and from the commercial banking system itself.

I am in favor of the independence of the Federal Reserve System from the Congress for appropriation purposes, and from the commercial banking system, but I am not in favor of the Fed's independence from the elected President of all the people.

Mr. GETTYS. Does this not control the pursestrings?

Mr. ROUSSEAS. If you are referring to the problem of political manipulation, I can only reply that I have great faith in the democratic process. I have even a greater faith in politicians, though I am not willing to rule out the possibility that they may abuse their power. They may. That, it seems to me, is a chance we have to take in a democratic society. But I do not want to go in the other direction and simply raise bugaboos about the abuse of political or executive power. This is a real possibility. It is, indeed, a problem. I am quite willing to face it, but then this is the problem that confronts all democratic societies.

Mr. KLEBANER. I think that the issue of independence of the Federal Reserve is very much exaggerated, both by its friends and by its opponents. If we look at the monetary policy of the last few

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years, we must be impressed by the fact that since President Eisenhower left office, the rate of money expansion has been very significantly higher than during his years, and I cannot help but think that this is surely in some way connected with change in administration thinking.

Mr. GETTYS. Regardless of what the Fed did?

Mr. KLEBANER. The Fed did provide the reserve basis which made possible this deposit expansion, and what I am suggesting, then, is that they indeed were following the election returns and to a great extent, at least, the thinking and wishes of the administration.

One of the most significant conflicts of modern times occurred during the Korean war in the summer of 1950. I do not know how many of us here would feel that the thinking of the administration at that point was superior to that of Mr. Eccles and the Board of Governors, and in the end, thanks to the intervention of Senator Douglas and other leading Members of the Congress, the Board of Governors prevailed.

Mr. GETTYS. One other question. My time is about expired. You can answer this yes or no.

Do each of you or any of you think that there is now statutory authority vested in any branch of the executive, any agency of the executive, to cure the situation that exists now with regard to unfair competition for money, if there is unfair competition, on the CD's? Do we need this legislation, in other words to alleviate the situation that confronts the country economically now?

Mr. CARSON. I suppose that the Federal Reserve itself could exercise power with respect to regulation Q that would have some effect. But aside from that I do not know.

Mr. ROUSSEAS. I do not know whether the Federal Reserve has statutory authority.

Mr. GETTYS. I believe that the Governors testified in effect that the Board now has authority to take such action that might cure this. Am I correct in this?

Mr. ROUSSEAS. If I am not mistaken the Board of Governors did come out and put unsecured bank notes under regulation Q. So in this sense they can.

Mr. KLEBANER. They are proposing it.

The CHAIRMAN. In opposition to the Comptroller.

Mr. CARSON. I object to the word "cure." I am afraid the cure is going to kill the patient. I tried to make it clear in my statement that I believe regulation Q created the crisis and if we would get rid of this type of price control——

Mr. GETTYS. You think you can do that only by legislation?

Mr. CARSON. No, I understand that regulation Q can be raised and can be effectively removed by Board action. As a matter of fact, when I was working in the Treasury several years ago we had an interagency committee meeting on regulation Q and at that time the Board was very much in favor of getting rid of it and the question arose as to whether this could not be done by simply saying, well, the ceiling is 10 percent or 20 percent or whatever is necessary.

Mr. GETTYS. Thank you. I would not object to your comment, but my time has expired.

The CHAIRMAN. Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

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Professor Rousseas, you indicated that you felt the tail was wagging the dog as far as Federal Reserve policy is concerned. I wondered in this connection if they could not have used an alternative policy in December and used the rediscount window as a substitute for increasing the rate under regulation Q—if they could not have solved this and thereby avoided using an interest rate which is taking the funds away from the savings and loans? Would this have been an alternative policy?

Mr. ROUSSEAS. There is no question in my mind that the Federal Reserve System does have the power to engage in open market operations as President Hayes has indicated, to offset the impact of CD's on excess reserves and thus the lending power of the commercial banking system. But this is precisely the issue that I am raising.

For example, I would like to bring to your attention the views of Mr. Sproul who argued in 1950 that the prewar monetary policy was much too gross and not a sufficiently fine instrument; that there was always the danger of overdoing things and curing an inflation by inducing a deflation in the economy. The whole postwar argument was that certain structural changes had occurred, because of the Second World War, which had now transformed monetary policy into, indeed, a very fine instrument for monetary policy. My position is that open market operations and discount rate changes could have come to grips with the problem you have raised, but then we would be right back where we were before the Second World War. What in other words, has happened to the "new" monetary policy that we heard so much about? This is the point I wish to raise. It is becoming again not quite the fine instrument we thought it would be.

Mr. TODD. In view of this, I wonder why they took the policy action they did in raising the interest rate by regulation Q, except that it gave the implication of a tightened money policy, since they felt at that time a tight money policy was desirable, and I would thoroughly agree with them on that. They took action which purported to do this. In fact there was not a tight money policy at all according to what the St. Louis Federal Reserve Bank indicated. It was a very loose money policy and it was loose until presently. As a consequence I wondered why they would take this mechanism, when perhaps an open market mechanism could have been coupled with more monetary restraint and it would not have affected the economic relationships of the various competitive financial institutions.

Mr. ROUSSEAS. I think there is a certain tightness of monetary policy at the present time, net free reserves are negative.

Mr. TODD. That does not mean much if they make borrowings available.

Mr. ROUSSEAS. On December 6 when they changed regulation Q (and I think a lot of people have missed this point), the Board of Governors stated flatly that the increase in the time deposit rates, and I am quoting, "is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy to finance their loan expansion."

I think, however, in fairness to the Federal Reserve System, that there is a theory that argues that velocity changes are not necessarily bad; that, indeed, they are a safety valve to monetary policy and per-

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mit the Federal Reserve to feel its way pragmatically to an optimum policy position.

Mr. TODD. It seems to me that any institutional mechanism which would increase velocity would have the same effect as an increase in the money supply. So if you make an institutional arrangement that would increase the velocity it is equivalent to a loose money policy.

Mr. ROUSSEAS. Take the Federal Reserve position——

Mr. TODD. There is no difference as far as monetary policy, is there?

Mr. ROUSSEAS. Yes, there is. By allowing for the long-term growth of the economy indirectly through velocity changes, the Federal Reserve is in much closer contact with the money market. It sort of has its fingers on the pulse, whereas increasing the money supply would loosen the Fed's contact with financial markets.

Mr. TODD. I would like to see a good mathematical proof of that.

Mr. ROUSSEAS. I do not agree with it, but this is an argument that can be made.

Mr. TODD. Would any of the other distinguished witnesses care to comment on the exchange we have had?

Mr. CARSON. I think the essential difference between money supply changes and velocity changes to provide for expansion in the economy comes through the interest rate, and I would contend that the interest rate will be higher where you rely upon velocity changes than where you rely upon increases in the money supply. Of course, this means that borrowers have to pay more and may mean that the rate of investment is lower at every level of the gross national product.

Mr. KLEBANER. I agree with what Dr. Carson just said and I would like to add in connection with the question you raised a moment ago, that indeed, in December, the Board of Governors did have the choice in the sense of opening the discount window wide instead of raising the permissible maximum rates. But as I saw the situation, this would have led to a number of undesirable repercussions. If we permitted the banks to make extensive use of rediscount facilities, in order to avoid excessive growth of the monetary supply there would have had to be Federal Reserve open market sales, which would have had adverse effects on the Government bond market. And this was certainly a consideration that must have been in their thinking.

Incidentally, I do not believe that at the time they really expected that interest rates were going to move up as quickly and as sharply as they turned out to have done. There were some indications at the time that they set what they thought was going to be a rather high ceiling, so there would be great latitude, and they were hoping that the institutions which would benefit from it would be the smaller banks. But of course recently, even the leading institutions have been paying very close to the ceiling.

The CHAIRMAN. Would it be satisfactory for the gentlemen to comment on this for the record?

(The information referred to follows:)

Professor ROUSSEAS. On the relation of interest rate, velocity, and money supply changes with respect to monetary policy, I refer Congressman Todd to appendixes A and B of my written testimony (see pp. 307–328).

(Professor Klebaner subsequently stated by letter to the staff, dated June 6, 1966, that he had no additional comments beyond his testimony.)

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(Professor Carson subsequently informed the committee that he had "No comment.")

The CHAIRMAN. Mr. Mize.

Mr. MIZE. First, I want to compliment all three of you. It is refreshing to see college professors here. I certainly would like to have my son study under any one of you.

What if the Fed had not taken its action in December?

Mr. ROUSSEAS. Well, this would have put an inordinate strain on the commercial banks and they would either have had to dump additional Treasury bills, or contract the volume of their loans, or refuse to make new loans. This would have had an inordinate impact on the credit of the economy.

Mr. MIZE. Well, supposedly, one of the goals of the Fed in doing what they did—what they did last December was to put a damper on the inflationary trends that everybody seemed to be concerned about. Do you think that was too violent a way of accomplishing this?

Mr. ROUSSEAS. Yes, I do.

Mr. MIZE. Do you feel that if the Fed lowered the ceiling on regulation Q back to 4½ percent where it was last December, that the problems being considered by this committee right now, a gradual return of funds would take place to savings and loans?

Mr. ROUSSEAS. That raises the whole issue of regulation Q and I would like to take this opportunity to disagree with my colleague, Dr. Carson on this matter. I am not for abolishing the requirements of regulation Q. It might very well be a sort of price control. But controls from my point of view are not bad per se and they have to be judged pragmatically and contextually, that is, in terms of their compatibility with the objectives of public policy. Ours is a mixed economy, it is not an economy of unbridled private enterprise, and this is a basic issue of public policy.

I think the whole crux of the problem of CD's is, indeed, regulation Q, and I think regulation Q could be made rather academic if we simply required identical reserve requirements on both demand deposits and time deposits and I would not be much concerned by regulation Q one way or another because commercial banks would have no incentive to compete aggressively for time deposits, not only with thrift institutions, but among themselves.

Mr. MIZE. That is an interesting observation.

One more short question. What in heaven's name do these banks, the large city banks that are paying the 5½ percent on CD's—where do they put this money? Where are they putting it?

Mr. CARSON. Well, I do not know exactly, but I suspect that some of it goes into municipal bonds that are tax-free and you have to recognize that the 5½ percent is only 2¾ after taxes, so I do not believe that they are doing this to their detriment. I think it is in their self-interest, otherwise they would not be doing it.

The CHAIRMAN. Mr. Ottinger?

Mr. OTTINGER. Thank you, Mr. Chairman.

Dr. Carson, I am rather interested in your grandstand play for the free market. This has been brought up by a number of witnesses and I think we all have a desire as one of the objectives of our monetary policy to have as freely determined an interest rate as possible. But it seems to me unrealistic in terms of the large degree of regulation we

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have at present, to talk in terms of unrestrained competition in the area of the money market.

How far would you go in following out the philosophy? Would you eliminate reserve requirements? Would you eliminate restraints on fraud? If we did what you suggested, eliminate regulation Q in order to be able to preserve any kind of meaningful supply of money to the various elements in the economy, would we not have to federally preempt usury laws? Would you eliminate the insurance on deposits that we presently have through the FDIC? How far would you go in order to realize your untrammeled competition?

Mr. CARSON. I would go all that far and perhaps a little further. I believe in freer entry into banking and less regulation of that entry. I have advocated openly, and I suspect that I am one of the few that do, the abolition of reserve requirements altogether on the basis of research that I have just completed in Illinois, where you know, State banks are not subject to any reserve requirement whatsoever and yet where they in fact hold something like an average of 12 percent of their demand deposits. I feel that we do not have to have this reserve requirement in order to have effective monetary control and I believe any control that is not necessary is a bad control.

Mr. OTTINGER. What you suggest might be feasible if we were starting over again to set up a system of monetary regulation from scratch. But we already have a sophisticated and established system of regulation, including the items I have mentioned previously. In view of this, the question now confronting us is really the relationship between the various institutions administering the regulations and the relative effect of their regulations on competing segments of the financial community.

Tell me, under your theory of "ideal" totally unregulated monetary system, what protection would you leave for the depositor to protect against the bank that is being badly managed?

Mr. CARSON. If I go so far as I said I was going in eliminating Federal deposit insurance, then I would have to say that there would have to grow up, and I think naturally would grow up a system of private insurance of commercial bank deposits and each bank would pay a rate which reflected the true risk that that bank bore in the acceptance of deposits, and this might logically lead to people depositing their money in the very largest and most diversified banks; and as I pointed out in arguing this point with Prof. Milton Friedman not long ago, this would lead to somewhat more monopoly than I would be prepared to have. But I would counteract that by a freer banking entry policy.

Mr. OTTINGER. Abolish the antitrust laws, too?

Mr. CARSON. No, sir; I think those are absolutely necessary as a final protection, if we go as far as I am prepared to go.

Now, I realize, having said this, that it is tremendously unrealistic to advocate such a program, because I have no doubt that Congress will not abolish reserve requirements and they will not abolish Federal deposit insurance and so on. But this does not dampen my belief that I am correct.

Mr. GETTYS (presiding). Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman. I wanted to compliment the professor, also.

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Professor Klebaner, on page 3 of your prepared statement, the third full paragraph, the last sentence you point out the tremendous increase in savings in this country between 1937 and 1966. Would you be able to supply for the record the gross amounts of savings in each of those years?

(The information referred to follows:)

Yearend total savings

[In billions of dollars]

	Savings and loan associations	Mutual savings banks	Commercial banks
1931	5.9	9.9	16.0
1936	4.2	10.0	13.7
1937	4.1	10.1	14.4
1946	8.5	16.8	33.4
1966 (January)	110.2	52.8	147.

Source: 1931–46: 1965 Savings and Loan Fact Book, p. 12; 1966: Federal Reserve Bulletin, April 1966, pp. 554, 567.

Mr. McGRATH. Do you know of any other country in the world where savings have decreased similarly in that same period?

Mr. KLEBANER. Well, we have the highest levels of national income and disposable income of any nation in the world, but I doubt very much that we are the most thrifty people in the world.

The more interesting comparison would be the proportion of disposable income which people put away. I do not have any figures on that before me. I would suspect for example that the Swiss are thriftier.

Mr. McGRATH. Of course they were not involved in World War II which makes some difference.

Professor Rousseas, as I understand part of your statement, when commercial banks issued CD's they generated excess reserves. What are some of the economic effects when excess reserves are generated?

Mr. ROUSSEAS. This permits the commercial banking system as a whole to expand its loans by some multiple of these excess reserves. For example, the multiplier in this case would be the reciprocal of the required reserves and also certain leakages into cash or reserves (the multiplier may be 2 or 3) and this creates secondary demand deposits.

Mr. McGRATH. We have a chart that shows an increase in 5 years, 1960 and 1965, of about $15 billion in negotiable CD's in that period. Would you have any idea as to the net amount of increase, of expansion in loans created by the issuance of $15 billion in CD's?

Mr. ROUSSEAS. I could not do this on the spot and I think the data would be very tricky to handle. You would have to make certain assumptions of different kinds of assets and so on. I think some attempt could be made. I could not give you a spot answer right now.

Mr. McGRATH. Is the creation of excess reserves normally a function of a central bank?

Mr. ROUSSEAS. Yes, controlling the amount of bank reserves—that is what we mean by monetary policy. When I say the central bank is sort of losing a part of its control, I am not saying that things have broken down into chaos. I do not want to put too much emphasis on the CD's. There are other explanations of velocity changes as well.

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CD's are a contributing factor. They are important to me because this is the only case that I know where the commercial banks can determine the amount of a money market instrument issued. If you take velocity changes, I would say they can be explained in several ways: The dumping of Treasury bills by the commercial banking system and the moving out of Treasury bills by nonbank corporations, as well as the issuance of CD's along with nonbank intermediaries have also contributed to velocity changes but by a rather small amount.

I have particularly in mind Warren Smith's study which shows that nonbank intermediaries, contrary to the expectations generated by the Gurley-Shaw thesis, were not important in explaining velocity movements in the postwar period.

Mr. McGRATH. Thank you.

The CHAIRMAN (presiding). Mr. Hansen.

Mr. HANSEN. Thank you very much. Sorry to be late. There is one question I have.

This question deals with the attempts that have been made to cool off the heat in the economy. I suspect from what I have read, that this was the intent when regulation Q was changed to permit a higher interest rate. This seemingly has caused some problems and an imbalance between various types of savings and financial institutions. That to my mind seems to be the problem we are trying to solve.

What in your judgment would have been the case had the interest rate proposition been left to stand as it was and if the reserve requirements had been used as a means of restricting credit in certain areas?

Mr. CARSON. Well, I think the answer is—I assume you mean an increase in reserve requirements in lieu of this policy.

Mr. HANSEN. Yes.

Mr. CARSON. Well, the increase in reserve requirements would have had a very pervasive impact on the entire member banks which constitute, I think something like 85 percent of the total deposits of the commercial banking system as a whole. This would have had immediately reduced the lending power of all member banks.

As far as I can see, these two policies are not alternatives. I am not at all certain that regulation Q was raised with the view in mind of raising interest rates. I think that was a result that was not entirely foreseen as Professor Klebaner has just pointed out. Indeed, the money supply has been rising at a very rapid rate since December and this is not indicative of a tight money policy.

Mr. HANSEN. That still does not answer the question completely. Why was the interest rate raised or regulation Q guidelines upped if it was not for the express purpose of making it possible to increase interest rates?

Mr. CARSON. I believe the express purpose was to get some very large banks off the hook. They were in a position where the current ceiling rate on their negotiable certificates would have been, in effect, demand cash and that money would have gone into other types of money market assets and this would have left these banks in a very tight situation where they would have to have sold other securities and tightened up their lending policy. I think the Federal Reserve wanted to avoid the crisis situation.

Mr. HANSEN. In other words, it has a loosening effect on money rather than a tightening effect.

Mr. CARSON. I believe so.

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Mr. HANSEN. I think my time is up.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

I want to join my colleagues in expressing my appreciation to the three witnesses here today and to say to them that I deeply appreciate their positions with reference to the Federal Reserve Board, that I share your opinion along with the chairman of this committee.

There is just too much independency in the various banking agencies and in view of the fact that time is short, I would like, Mr. Chairman, to yield to Mr. Rees so that these witnesses can make comments on his bill.

The CHAIRMAN. Without objection, Mr. Rees will be granted additional time.

Mr. REES. Thank you, Mr. Chairman.

One of the major reasons I introduced H.R. 15173 is that I thought it would be best to try to define a certificate of deposit. I felt we should be more profound. In California we have had problems with smaller banks and building up the "hot money."

No. 1, when we talk about regulation Q, I would just like to explore what you think might have happened if there were competition of interest rates between banks and savings and loans. I am from California where we traditionally pay a half to a full point more for our money because we are a capital-short and an expanding State. Savings and loan institutions are primarily investment institutions. We find on the average, that 53 percent of the deposits are in accounts of $9,000 or over, something like 79 percent are in accounts of $5,000 and more. What do you think would have happened if we abolished all restrictions of regulation Q, and on savings and loans? What do you think would have happened in terms of competition between the savings and loans and the banks? Do you think that the rate for both of them would have been higher than 6 percent or lower, or what?

Mr. CARSON. I think it would be today what it would have taken to bring about equilibrium in a market which would be actively competing in the marketplace for funds. I am not at all sure that the time to abolish regulation Q is at a time of crisis. I think the orderly procedure would be for the Federal Reserve or the Congress to legislate it away when it was not really effective. I would say that the answer to your question is, what happened when they did raise it to 5½, because 5½ was quite unrealistic in terms of other rates, was a fairly orderly but somewhat painful process of deposit shifts from S and L's into commercial banks.

Mr. REES. Do you think there should be a parity between what a bank can pay and what a savings institution can pay? In California the average yield of portfolio is 6.4 percent. I think you need about a point spread if you are going to make any money at all. The savings and loan institutions, if they have to pay 5.5, they are cutting in pretty deeply into their profits. Also, they are handling paper that is 25- and 30-year paper. They have a very rigid portfolio while a bank of course has long-term and short-term paper and can readjust. With this problem of having a rigid portfolio, do you think in developing monetary policy, that you can say thrift institutions, because of the nature of their investments should be given a half point or parity position, or whatever you want to call it?

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Mr. CARSON. Yes, if it is congressional policy to encourage and subsidize investment in housing. This apparently is the rationale for a lot of our past policies in this area.

I would suggest, and I think in my statement we do suggest that we examine this proposition—reexamine this proposition and our whole attitude toward subsidization of housing and other types of economic activity. It could be that we have had a tremendous misallocation of investment resources. If, as I think I say correctly, the rate of return in education is higher than the rate of return in investment in residential housing, we have had too much housing and not enough education. Somebody calculated the value of a master of business administration degree is on the order of 30 percent on investment. I do not know what it is on housing, but I do not think it is quite that high.

Mr. REES. Maybe one of the others would have a comment in terms of this problem of competition between two types of institutions for investor dollars.

Mr. KLEBANER. I made reference to this problem briefly in my written statement and I would only like to underscore that before regulation Q can be abolished, and I hope the day will come, a number of other changes have to take place. Among other things, savings and loan associations should be granted expanded powers which in effect will permit them to operate in many, if not all of the fields that are currently thought of as part of commercial banking.

As your facts clearly indicate, it is almost inconceivable that savings and loans in California, which are highly important in the local economy, and paying the highest rates in the Nation, should be able to offer very much more than 5½ percent and survive as viable organizations.

Until very recently this issue did not come up because they had enough of a lead over commerical banks incomewise to permit them to pay very much above what the commercial banks saw fit to offer depositors and of course the savings and loans expanded by leaps and bounds in your State and to a lesser extent elsewhere.

Overnight savings and loans cannot transform themselves into institutions which can offer very much, if anything, beyond 5½ percent. This may therefore necessitate for the short run some measure of relief for these institutions. But I would hope that it would be no more than a temporary measure and once various changes occurred elsewhere we would eventually remove the variety of restraints and restrictions that currently handicap competition among financial intermediaries.

I should like to say commercial banks might feel that at long last the shoe is on the other foot, because after all, for many years they were the ones who were being confined and handicapped. Then at last they finally decided to move seriously into the savings market, an extensive low-profit market—commercial banks, too, find it not very appealing to have to pay 5 or 5¼ percent for money which they in turn relend at a very little above that. It is clearly low-profit business. In fact, 2 years ago, an executive of the Mellon Bank pointed this out and was very unhappy about the situation. But competition has forced this.

Mr. REES. This is what has happened in the banks, not only are they drawing new money, but old money that is already there, is converted from a passbook account into a higher paying CD account.

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Mr. KLEBANER. It means their interest bill has risen sharply and will presumably continue to do so.

Mr. REES. One more question. Do you all agree that we need to develop more coordination between the various agencies that make various decisions? Both Mr. Horne and Mr. Saxon said they never even heard of the December regulation Q change until they heard about it in the newspapers.

Mr. KLEBANER. I testified last year before Representative Multer's subcommittee which was considering at that time legislation to establish a Federal Banking Commission. I would hope that the Congress will turn its thoughts to this area in the near future. This recent situation is another of many demonstrations of the importance of such an arrangement.

Mr. REES. Thank you.

The CHAIRMAN. Well, I just want to pursue one or two questions if you gentlemen feel it is all right.

We will go a little bit after 12.

Has the money supply been helped or harmed or not changed at all by the introduction of the enormous amount of negotiable CD's? In other words, in 1960, at the end of the year there were about a billion dollars in negotiable CD's. Now, we have $17.5 billion. During that time has our money supply increased by reason of those CD's or has it gone down?

Mr. KLEBANER. Our money supply increased more rapidly in the period since December 1960 than in the comparable preceding period, sir.

The CHAIRMAN. You say 1960. That is the time when the CD's——

Mr. KLEBANER. Early 1961.

The CHAIRMAN. Do you attribute that to the CD's?

Mr. KLEBANER. I do not. I attribute it more fundamentally to the thinking of the Board of Governors that the new administration was interested in easier money than had prevailed in the last years of the Eisenhower administration.

The CHAIRMAN. How do you gentlemen feel about that?

Mr. ROUSSEAS. I have some data here which I have submitted to this committee in the appendix to my statement. I take the last half of each postaccord expansion. For example, from 1963 first quarter to 1965 third quarter, the money supply increased at about 4.2 percent per year compounded annually, which is a very respectable rate of growth. The growth rate of velocity on the other hand has been 3 percent per year. If you look at it in terms of the Eisenhower years of 1956 to 1957 third quarter and 1959 second quarter to 1960 second quarter, the growth rate in the money supply in the first period was six-tenths of 1 percent, and in the second period, a negative growth rate of 1.8.

Now, my impression was that the Federal Reserve had learned its lesson because of the low rate of economic growth in the 1950's. And I was very pleased to see the Fed move again toward allowing the money supply to grow at an adequate rate from 1963 to the present. My alarm, however, at the present time is with the Fed's disagreement with the administration and its move toward higher interest rates and a tight-money policy. I cannot predict what will happen, but there is some concern in my mind that again the Fed may be moving toward

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restricting the money supply unduly in terms of what they see as a developing inflationary situation. But up to the present time (post-1963) the money supply has grown at a very adequate rate.

The CHAIRMAN. Dr. Carson? What do you say about this? Just this one question, please.

Has the enormous growth in negotiable CD's from $1 billion in 1960 to $17.5 billion now caused the money supply to be larger, smaller, or not affected?

Mr. CARSON. I do not know what the precise connection between the rate of growth of demand deposits and the rate of growth of time savings deposits is. To some extent this great growth in negotiable CD's may have been at the expense of a similar growth in demand deposits.

Since 1960 demand deposits growth has not been very substantial. A lot of the money supply growth—a lot of this has been in the savings area.

The CHAIRMAN. You emphasized one point that has been made by a number of witnesses and that is, that the CD's have not created any additional growth, that they have just transferred the money around from one institution to another, I think from the demand deposits to the time deposits and from savings and loans to the banks. Is that your understanding?

Mr. CARSON. I believe that is correct.

The CHAIRMAN. Another point I want to bring out, about the independence of the Federal Reserve. I think there is so much misunderstanding about that.

No. 1, we have three branches of Government. We do not have four. We do not have legislative, executive, judicial and Federal Reserve. We have recognized that. The power from money of course is in article I, section 8 of the Constitution which says that Congress shall have the power to do a number of things—to lay and collect taxes, duties, imports and excises—to promote general welfare, regulate commerce, to establish a uniform rule of naturalization, to coin money, regulate the value thereof, establish post offices and post roads and all these different things.

Now, of course, many people who advocate the independence of the Fed say that it is only Congress who can do that. Congress only can do that. Therefore Congress can coin money. That is just up to Congress and not this or that agency that has been created. I think it is very plain that Congress has the power all right under the Constitution. But it says, at the end of these powers that are granted how they shall be exercised by Congress. It says:

> To make all laws which shall be necessary and proper for carrying into execution the foregoing powers and all other powers vested by this Constitution in the Government of the United States, or in any department or officer thereof.

In other words, Congress has the power to make the laws to carry them into execution. Well, of course, the next article of the Constitution deals with the executive and its says the executive power shall be vested in a President of the United States of America.

So these agencies are no different from any other agency. They are created by Congress by the passing of a law and the Constitution says that each and every law shall be executed by the President of the United States. Do you see in that any claim there for independence?

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Dr. Carson, what do you think about that? Under the Constitution do you think they could be independent of the Government?

Mr. CARSON. Not under the Constitution.

The CHAIRMAN. Mr. Rousseas?

Mr. ROUSSEAS. My reaction would be that Congress is still creating money, having created Federal Reserve by an act of Congress. I do not see any great contradiction there at all. But I do see a contradiction in the sense that independence is usually taken to mean independence from the executive branch of the Government.

The CHAIRMAN. That is right. The point that I am making is, they are still under the executive, because it is not a four-branch Government. What do you say about that, Mr. Klebaner?

Mr. KLEBANER. I would think we certainly do not have Federal Reserve independence of the Government—it is independence within the Government. And I certainly would like to see as much coordination as possible among the different branches of the executive.

The CHAIRMAN. You put your finger right on it. I had a little something to do with the Employment Act of 1946. It was written over there in the Speaker's hideaway, what we call the "Sanctum Sanctorum," or the "Board of Education," as some people used to call it, where Members would meet at the end of the day. That law was written there and I could tell you everybody who was there at different times. We called it the Full Employment Act. We had an awful fight in the House as well as in the Senate, but the only major change that was made in that bill from the time it was introduced until it came out was that "Full Employment" was changed to "Maximum Employment." That was the only real substantial change in my book that was made in that bill. That bill was for the purpose of requiring coordination of Goverment activities for the public interest and the word "coordination" is in there, the word that you just mentioned. That is the reason the Fed, I think, is entirely wrong in trying to go its own way, not even coordinating with the President, not even coordinating with the Secretary of the Treasury or the Federal Home Loan Bank Board or the Comptroller of the Currency or the FDIC or anyone. Just on their own. And that is in violation, if I know anything about the Employment Act of 1946—that is clearly in violation of the Employment Act of 1946.

Have you gentlemen seen the hearings we conducted in the Joint Economic Committee on December 13 and 14 on the Fed's action on December 6?

Mr. ROUSSEAS. I have not seen them.

The CHAIRMAN. Be sure and get it. If you do not get it there at the committee I will send it to you. They are very interesting. When you see the hearings we conducted on the cancellation of the unneeded part of the portfolio in the Federal Reserve System—have you seen those? I am going to see that you get those. The Fed has $40 billion of Government money in the Federal Reserve Bank of New York. Those bonds, every one of them, have been paid for once. Now, that sounds shocking, but we still pay interest on them. But it can be documented. Over the years, I have interrogated Mr. Sproul, whom you mentioned a while ago, Mr. Eccles, Mr. Martin, and other people prominent in the Federal Reserve and I have it down in black and white in answers to questions, that every one of them considered those

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bonds paid for once. But they are not canceled. The public is still paying about $1,700 million interest on those bonds every year. When the Fed took one form of Government obligations which is the Federal Reserve note, backed by the Government, an obligation of the Government, and traded those notes for another form of Government obligation, then it seems to me that one of them should be canceled. Both of them should not remain in circulation. It does not make sense to me.

They are still paying interest on those obligations.

Now, have you gentlemen given any thought to it at all? What about you, Mr. Klebaner?

Mr. KLEBANER. I suppose the ultimate issue is simply whether or not the Federal Reserve should go to the Congress for its appropriations.

The CHAIRMAN. That is one thing, of course. They want to get away from appropriations. Why take $1,700 million away from the taxpayers every year to get $200 million?

Mr. KLEBANER. The bulk of the net earnings of the Federal Reserve banks from these bonds is returned to the U.S. Treasury and only what they need for their operations they hold back.

The CHAIRMAN. They are taxing people for something that has been paid. It is a matter of principle that is involved here. It is hard to get around it. Why, they even pay dues to the American Bankers Association of $90,000 a year. Yes, a Government agency—the Federal Reserve—belongs to the American Bankers Association. I hope you will give some consideration to that and if you will comment on it in the transcript when you look it over about those bonds, whether or not they should be allowed to be outstanding.

I am going to send you the hearings and I hope you will comment on them.

Thank you, gentlemen, you have been very helpful to us.

We will stand in recess until tomorrow morning at 10 o'clock and we will have Mr. Randall of the FDIC and the American Bankers Association representatives.

(Whereupon, at 12:15 p.m., the committee adjourned, to reconvene at 10 a.m., Thursday, June 2, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, JUNE 2, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Mrs. Sullivan, Reuss, Ashley, St Germain, Minish, Weltner, Grabowski, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Widnall, Fino, Stanton, and Mize.

The Chairman. The committee will please come to order.

This morning the committee continues public hearings on H.R. 14026, concerning certificates of deposit.

Our witnesses are Hon. Kenneth A. Randall, Chairman of the Federal Deposit Insurance Corporation, and Mr. W. G. Kirchner, representing the American Bankers Association.

Both these gentlemen are closely associated with the commercial banking industry. I would like to reassure them that while this committee does not want to discourage banks from seeking savings, we are determined that the current rate war—not just between banks and the thrift industry, but among banks themselves—be halted immediately. Also, we are equally determined that excessive use of certificates of deposit by New York banks to attract corporate funds also cease. All our witnesses have recognized that there was a liquidity crisis among our money market banks last December, that their inability to roll over CD's was the cause of that crisis, and that the Federal Reserve Board came to the rescue by permitting these banks to pay up to 5.5 percent on 30-day time deposits.

Of course, the Federal Reserve has been the cause of the problem to begin with, by the fact that the Federal Reserve Bank of New York invented the modern negotiable CD in 1960 and encouraged First National City Bank and others to use it to attract hot money. Several smaller banks have copied these large banks and gone broke—their doors closed for the last time. So when bank supervisors actually encourage such excesses and then fail to do something about it, then we indeed have not only a liquidity crisis, but also a supervisory crisis.

It would be helpful if both of our witnesses this morning would comment on the effect of the Federal Reserve's rate war on the smaller bank—is it harmful to them, particularly as their own passbook savings deposits and demand deposits are converted to high-cost CD's?

Many small banks have written me that while they have issued time certificates for many years and hope to continue, they deplore the

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Federal Reserve's drastic increase to 5.5 percent interest last December. If they do not meet these high rates, the money goes to the city; and if they do pay the high rates, they are forced to seek high yield, risky loans with a clearly inflationary impact. So both the small bank and the thrift institution may be badly hurt by this senseless rate war and Congress just will not stand for that.

I suggest each witness take 15 minutes to summarize his testimony, and then the members will ask you questions and will probably bring out the points you want to make anyway. In the event you find it is not brought out, you will be privileged to do so and you may also revise your remarks to bring in any points that you think you should bring in.

Mr. RANDALL. Mr. Chairman, first of all, if I may, I would like to acknowledge that Mr. W. W. Sherrill, a director of the Corporation, is with me. This is his first visit to the committee. I would like to introduce him.

The CHAIRMAN. We are delighted to have you, Mr. Sherrill. He is from a good State, I understand.

Mr. RANDALL. Indeed he is, sir.

Mr. Chairman, we have been working very closely with elements of the administration, with the Council of Economic Advisers and with the Treasury. We have a rather comprehensive statement.

The CHAIRMAN. It will be placed in the record at the conclusion of your oral remarks, if it is all right.

Mr. RANDALL. It is a very difficult piece to summarize, Mr. Chairman, and it has a proposal that we have worked out. It received final clearance last night from the Bureau of the Budget and it is a difficult thing to summarize, sir.

I recognize the time pressures are upon you and upon this committee.

The CHAIRMAN. If I judge correctly, it will take you about 45 minutes to read this.

Mr. RANDALL. It is a fairly long and fairly comprehensive statement.

The CHAIRMAN. How long is your statement, Mr. Kirchner?

Mr. KIRCHNER. I feel about a half hour for Mr. Davis' statement and I would like 5 minutes or so to add my own thoughts, if I might.

The CHAIRMAN. You gentlemen might have to come back and answer questions. I suspect it would be better from your standpoint, Mr. Randall, to summarize as best you can, 15 minutes and Mr. Kirchner the same way and we will place your statements, your entire statements in the record.

Mr. RANDALL. All right, sir.

The CHAIRMAN. You may proceed that way.

STATEMENT OF HON. K. A. RANDALL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION; ACCOMPANIED BY W. W. SHERRILL, DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. RANDALL. Mr. Chairman, we are pleased to be here today to submit the posture of the Corporation relating to the bills that have come before this body and to comment on some observations that we have made as a result of listening to and reading the record that has been created.

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We recognize the concern of the sponsor of the bills over the current conditions prevailing in the financial markets. We are concerned that some of the stresses of the markets may have created problems of lack of quality in loan portfolios and we wish to state that in the Corporation we are making every effort to exercise great care in the supervision of quality of credit in insured nonmember banks.

We do think there are several special factors in the market forces in the environment that currently we are involved in that do deserve your thoughtful and special consideration. We would first of all like to state that we do have confidence in the strength of our financial system. We do not feel that we are in the midst of a crisis, nor is there evidence to suggest that one is in the offing. This is not to say that the financial community is now free of problems.

But we are concerned that failure to understand the basic factors or misinterpretation of past developments could lead to incorrect diagnosis of our problems and to the adoption of inappropriate remedies.

We feel that many of the competitive pressures being felt by nonbank financial intermediaries stems from the fact that banks as multipurpose financial institutions are able at this time to attract funds on terms that are generally more favorable than those offered by financial institutions designed only for one purpose. We believe that clearly, this advantage would be reduced if both were subject to identical ceilings on payments for the use of funds.

We believe that although there have been several factors leading to the problems in the current market, the shifts and the readjustments that have come about and the shifts and the intensity of demand within the differing sectors of the economy, that these problems did not come about, nor were they urgent until there was an appearance of market pressures that began to force the rationing of scarce financial resources among competing uses.

We would like to point out that there is nothing new or unique or devious about these familiar transactions of certificates of deposit and the other deposit procedures used by banks and other financial intermediaries. The essential feature is not the instrument, its form or maturity or negotiability, but rather it is the capacity of banks as multipurpose financial intermediaries to pay more at this time for funds than the single-purpose institution that is most critical. This is an advantage that may shift as it has in the past, when the housing boom favored the nonbank financial intermediary.

Banks have gone through a period of historically high liquidity following World War II, but in the last 5 years we have witnessed new elements on the economic scene. In the first place, and very importantly, our international balance-of-payments position has become a major factor in the economic policy decisions as we have had payments deficit persisting.

A second and more important factor that has led to this point has been the duration and the strength of the current economic expansion. Domestic credit demands have increased in intensity and have been complicated by our international commitments. We have also seen customers of institutions change their patterns with increase in demands for credit for the purchase of so-called big ticket items, such as automobiles, housing, and with this the more flexible financial institutions have been able to find a more profitable investment of funds and the flexibility has proven beneficial to them.

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We have seen in this period of time banks tapping new sources of funds and this coincided with the large corporate balances available for short-term investment. A large part of these balances was being invested prior to the early 1960's in commercial paper and in the U.S. Treasury bill market. Much of it we feel has been withdrawn from bank deposits yielding no return to the holder.

The introduction of the large certificates succeeded in attracting a significant share of these corporate balances to banks. It is difficult to tell whether these balances will continue to be a major contributor to deposit growth in banks at the rate of the past several years, but there is increasing evidence that the growth in these investable balances has slowed down. The financial community has adjusted satisfactorily to this new money market instrument. And the reversal of this evolutionary process would be of dubious value to the economy as well as quite difficult.

Let me point out that certificates of deposit are not just money market instruments. They have been offered by banks for a long period of time and especially in the Midwest, have a long and important history. A survey of time and savings deposits conducted by the Federal Reserve——

The CHAIRMAN. When you refer to certificates of deposit, please specify those that are interest-bearing and those that are negotiable or not negotiable.

Mr. RANDALL. Primarily those in the Midwest, Mr. Chairman, have been of the nonnegotiable variety. There have been interest-bearing certificates and they have a long history. In many banks, even today in the Midwest the entire savings department of the banks still may be made up of certificates of deposit. This has been a factor in the agrarian Midwest.

The CHAIRMAN. Have they been primarily nonnegotiable, or negotiable?

Mr. RANDALL. Primarily nonnegotiable.

About three-fifths of the total certificates of deposit have been concentrated in the three midwestern Federal Reserve districts in Chicago, St. Louis, and Minneapolis. We find it is very difficult to see any justification for outlawing a deposit contract that has long been used by banks and is fully understood by depositors.

The CHAIRMAN. Are you still talking about negotiable?

Mr. RANDALL. I am talking about it in this case. There was one bill, Mr. Chairman, that would outlaw certificates of deposit, both negotiable and nonnegotiable.

The CHAIRMAN. What is the number of that bill?

Mr. RANDALL. I can give it to you, this is the bill, H.R. 14422, that would prohibit insured banks from accepting time deposits in amounts less than $15,000. We think this would be exceedingly disruptive and most difficult to the banks in the Midwest part of the country, especially.

The CHAIRMAN. Only one bill, H.R. 14026, is now before the committee. Now, Mr. Ottinger will have the privilege of offering his bill, H.R. 14422, as an amendment, that is true. But at this point it is not before the committee.

Mr. RANDALL. Your letter, Mr. Chairman, asks us to comment on all of these bills.

The CHAIRMAN. We understand that, but please be specific.

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Mr. RANDALL. And in the summary, this is one of the problems, Mr. Chairman, of trying to summarize.

The CHAIRMAN. That is right.

Mr. RANDALL. I apologize to the committee——

The CHAIRMAN. I see how difficult it is.

Mr. REUSS. Just one question. You referred to the chairman's letter of this week?

Mr. RANDALL. No, sir; we hope to have a letter to the chairman today on the one that we received yesterday morning, Mr. Reuss.

We do have problems in this Midwest section, Mr. Chairman—I will lead up to that point.

If I may, I would like to go over just a little some of the history of the changes in this.

Prior to 1962 banks had liquidity that they were using and there was little competitive pressure in this area of time and savings market. In 1962 there was an adjustment allowing banks to become competitive with the nonbank financial institutions. A differentiation of the ceiling rates on time deposits from that on savings deposits was introduced in November 1964, primarily for balance-of-payments reasons. At first this differential was only one-half of 1 percent and had only a moderate impact on money flows within the domestic economy.

In early December 1965 this differential was widened to 1½ percentage points. At that time, the impact of the action on particular segments of the market was difficult to foretell because of the increasing complexity of financial markets.

The CHAIRMAN. Off the record.

(Discussion off the record.)

(The chairman at this point departed the hearing room and Mrs. Sullivan assumed the chair.)

Mr. RANDALL. I will begin again.

In early December 1965 this differential, referring back to the one-half differential between savings and time deposits, was widened to 1½ percentage points.

At that time, the impact of the action on particular segments of the market was difficult to foretell because of the increasing complexity of the financial market. The movement of rates toward the ceiling by banks in the leading financial centers was more rapid than had been anticipated. A differential of this size tends to provide a very strong inducement for banks to develop new instruments to attract funds. Since that time, we have seen a wide variety of deposit contracts spring into use, such as savings or investment certificates and savings bonds. The contracts themselves, however, are not really new—after all the U.S. Treasury invented the savings bond long ago, but banks have entered actively into the market for small savings that are responsive to interest rate spreads.

Restrictions designed to influence the markets for financial savings are liable to have unintended results. In any event, we have too little knowledge of the patterns traced by funds as they move about our economy to be able to predict with any degree of accuracy the responses banks may have to restrictive action. The FDIC and the Federal Reserve are now conducting surveys of interest rates and other terms offered on time and savings deposits in banks. We believe these will give us more knowledge. Hopefully we hope to have preliminary readings on this material by the middle of this month and should know

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and have close knowledge of some of the changes, types of outstanding instruments, rates and other terms to give us a better insight into bank responses to these changes in interest rate ceilings.

Nevertheless, the limited evidence tends to indicate that smaller banks would be disadvantaged as opposed to the larger institutions if restrictions were placed on time deposit facilities offered by banks.

We are concerned in this regard because of the 12,000 small banks in this country, those under $25 million in deposits. They have a concentration of almost three-fourths of their savings in time deposits in accounts of less than $10,000. The banks between $25 million and $500 million have 60 percent of their accounts in this range and the banks over $500 million have over 38 percent in this range. Small banks are essentially confined to local and regional markets and thus to the smaller savings market. As the accounts become larger, there is an incentive for the holders to shift their funds to a larger bank. The inducement increases if there is also an interest incentive and this is one of the problems being posed today.

We believe that these figures illustrate some of the problems that would be posed for small banks if restrictions were placed on their ability to compete for deposits. Not only would the small banks be disadvantaged in relation to larger banks, but their competitive position in relation to nonbank financial institutions would be weakened.

If the same interest rate limitations were applicable to both banks and savings and loan institutions, large banks would maintain their advantage. Deposit insurance and share account insurance gives smaller banks and savings and loan institutions equal drawing power with large banks only up to the insurance limit, given the same interest rates. Because size tends to be equated with strength, funds above the limit would be attracted to the larger multipurpose institutions or into higher yielding investment outlets.

The various forms of time deposits with higher permissible rates of interest designed to attract the small saver have had an undeniable impact on the flow of funds into banks—an impact that has also affected other savings institutions. It is difficult to gage the magnitude of the impact. Many other economic forces have been influencing the flow of funds—the strength of the current business expansion and capital spending, to mention only two. Beyond question, changing economic conditions have contributed importantly to the development of these new patterns in the flow of savings. As a general principle, I think it is unwise to tamper with economic developments that evolve out of the natural operation of market forces. Nonetheless, as agents of responsible government, it is incumbent upon us to facilitate economic adjustments in transition periods so that we may realize desirable objectives with as little friction as possible.

Time as well as savings deposit contracts have long been useful in our banking structure and it would be a serious error to deny to banks access to any particular segment of the savings market. No constructive purpose would be served by altering or limiting deposit contracts when the principal factor responsible for our current concern may be the rate pattern and structural changes in the financial community rather than the form of contract.

Actions to modify the rate pattern should therefore be undertaken with caution because they may have unforeseen and unfortunate

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repercussions. Their impact could be highly uneven among geographic regions or among different types of financial institutions and markets. Small banks and other small financial intermediaries may discover that they are being hurt by measures taken to deal with another problem. These are just some of the considerations that the supervisory authorities of financial institutions must take into account in weighing the various courses of action open to them.

Serious imbalances could develop in our economy from the diverse effects on institutions of varying interest rates and this can both complicate as well as prolong the adjustment period. Moreover, burdens imposed on institutions and individuals in the course of the transitional period may be unnecessarily heavy. Accordingly, I am convinced that consideration should be given by your committee to a program that would provide the machinery necessary to avoid or mitigate disadvantage to individuals or institutions.

In the deliberations of your committee I commend for thoughtful study a plan along the lines proposed by Henry H. Fowler, the Secretary of the Treasury, as a promising basis for temporary relief in this troublesome situation. The proposal for differential interest rate ceilings with higher interest rates permissible on a bank deposit contract in excess of a specified dollar amount is good. However, to be realistic and workable the cutoff point should be quite high—in my judgment at least $100,000. It is a fact that permitting higher rates on big deposits will give large banks a competitive advantage over small banks whatever the cutoff point may be, but the higher the cutoff the less will be the impact on small banks. However, this would only be true if interest rate differentials were not large enough to stimulate a flow of deposits either between categories of banks or between banks and alternative investment opportunities in the market. Furthermore, the impact on small banks would be lessened if the duration of the proposal also was limited to 1 year to allow time for the necessary market adjustments.

The setting of a ceiling rate—at whatever dollar amount—has a disadvantage of encouraging brokers to reenter the market for bank deposits. Many in this committee have reason to recognize the problem of brokers in this market.

We have discussed this at length at prior times. Such broker activity cannot be effectively regulated under our current interest rate authority. The enforceability of interest rate ceilings should be strengthened by the enactment of legislation we have proposed to accomplish this object.

But quite apart from the details of the proposal by Secretary Fowler, as I read the testimony of the witnesses who have appeared before your committee, I am convinced that the first and essential feature of any program should be maximum flexibility in its operation. Give maximum flexibility—with flexibility it will be easier to promote adjustments suited to changing circumstances and thus avoid the constraints of a statutory enactment that would build rigidities into our economy and also encourage the development of circuitous channels for avoidance. With maximum flexibility, it would be possible to rely as much as possible upon the interaction of economic forces in the marketplace. Flexibility will permit action by Federal authority when action is necessary—and only to the extent that it is necessary.

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Further, it will permit relaxation of controls in favor of the operation of market forces more rapidly.

In achieving the necessary degree of flexibility demanded by the present situation, I think that it would be desirable to provide a statutory basis for fixing interest rates straight across the board. This means that interest rate ceilings should be established for banks and for nonbank financial institutions on some consistent basis. To bring this about it would be necessary to lodge the authority for establishing such rates in a single Federal agency or parallel authority with effective coordination such as provided in sections 4, 5, and 6 of the proposed Federal Deposit and Share Account Insurance Act of 1965 sponsored by the administration and introduced at the request of the Secretary of the Treasury as S. 2561.

As matters now stand, imbalances can emerge because interest rate controls are not applicable to all financial institutions. Establishment of authority over interest rate levels with an agency or agencies, such as mentioned above, should carry with it the power to differentiate rates with respect to the class or type of obligation issued by the financial institution. To illustrate, this power would permit the establishment of a 4-percent interest rate of interest on passbook savings accounts of commercial banks and similar obligations in competing institutions such as savings and loan associations and mutual savings banks. This power would also permit establishment of a higher rate on time funds and on various additional types of obligations—for example, large certificates of deposit that are essentially money market instruments and so recognized in the financial community. For instance, interest rate ceilings could permit differentiation between CD's in denominations above and below $100,000.

Taken in its entirety, my proposal with respect to the problem of interest rate ceilings could make use of any classification of credit instruments to handle any such situation that arises with maximum flexibility. This solution would provide the degree of discretionary control needed for situations such as the one we are currently facing.

I commend this approach to your committee for its thoughtful consideration. The proposal is essentially a simple one—broad powers to regulate interest rates flexibly to deal with specific troublesome situations—such as regulatory authority to be accorded sufficient power to discharge its responsibilities. This approach, in my opinion, will ease transitional periods such as the one in which we now find ourselves and could be used to forestall the emergence of similar situations in the future. It makes possible as much or as little control as the situation demands within broad guidelines.

We are advised by the Bureau of the Budget that there is no objection from the standpoint of the administration's program to the submission of this statement.

Mrs. SULLIVAN. Thank you, Mr. Randall. We will withhold questioning of you until Mr. Kirchner gets through summarizing his statement.

(The complete statement of Mr. Randall follows:)

STATEMENT OF HON. K. A. RANDALL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. Chairman, I am pleased to have the opportunity to submit to the committee the views of the Federal Deposit Insurance Corporation on H.R. 14026, a bill

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which would require the Corporation to prohibit insured banks from issuing any negotiable certificate of deposit, note, debenture or other negotiable obligation which is issued at a discount, or is interest bearing, or otherwise yields any return. The subject with which this bill is concerned is important to us and we have been giving it close attention.

I shall also present the Corporation's views on H.R. 14422, a related bill which would amend section 18 of the Federal Deposit Insurance Act to prohibit an insured bank from accepting time deposits in amounts less than $15,000, and from making any loan upon the security of a time deposit in an insured bank in any amount such that a difference between the loan and the time deposit would be less than $15,000. In addition, my comments are relevant to your bill, Mr. Chairman, H.J. Res. 1148, which would establish a ceiling of 4½ percent, unless a higher rate is approved by the President and the Board of Governors of the Federal Reserve System, for deposits in all commercial banks; as well as legislation proposed by Mr. Rees, H.R. 15173, which would prohibit negotiable obligations of banks yielding any return and permit interest only on time deposits held for a year at the same rate as paid on savings deposits held for the same period.

Each of these bills attempts to alleviate the competitive pressures existing today in the financial markets through the imposition of restrictions on time deposits—although in different ways.

The Federal Deposit Insurance Corporation recognizes the concern of the sponsors of these bills over the conditions now prevailing in the financial markets. We are following closely the quality of credit in the insured nonmember banks directly under our jurisdiction, as well as the overall economic situation. The extended period of economic expansion since 1961, accompanied by intense demand for capital, high levels of interest rates, and pressures on the economy from the Vietnam conflict, has undoubtedly encouraged some banks to be less cautious than theretofore in their lending and investment activities. The quality of credit can deteriorate unless unusual care is exercised by both the bank and the supervisory authorities. We are making every effort to exercise such care in our supervision of insured nonmember banks.

Turning to the current situation in the financial markets—a situation which has given rise to expressions of concern, I think several factors deserve your special consideration. So I shall endeavor to isolate for you the principal forces at work so that we may gain a better understanding of the current environment—how we arrived at the present situation and what we might do about it.

First, let me stress my confidence in the strength of our financial system. We are not in the midst of a crisis nor is there evidence to suggest that one is in the offing. This is not to say that the financial community is now free of problems. Nevertheless, failure to understand the basic factors or misinterpretation of past developments could lead to incorrect diagnoses of our problems and to the adoption of inappropriate remedies.

Much of the competitive pressure being felt by nonbank financial intermediaries stems from the fact that banks as multipurpose financial institutions are able at this time to attract funds on terms that are generally more favorable than those offered by financial institutions designed for only one purpose. Broader investment opportunities and a wide variety of financial services give the multipurpose institution an advantage over the single-purpose institution in attracting customers. Clearly, this advantage would be reduced if both were subject to identical ceilings on payments for the use of funds.

Generally speaking, in the early postwar period the flow of funds evidencing financial savings was attracted to nonbank financial institutions because these intermediaries could and did pay more than the maximum rates permitted banks. As savings began moving into the market through different channels due to the success of commercial banks in securing time money, the financial community faced the need to make some competitive readjustments. Shifts in the intensity of demand in different sectors of the economy reinforced the need for readjustment. But the need did not seem urgent before the appearance of market pressures that began to force rationing of scarce financial resources among competing uses.

Much of the recent growth in bank deposits has been in the form of time certificates of deposit. However, the present situation did not develop from the use of this money market instrument but from a changed set of relationships among financial institutions and within the financial markets. After all, banks have for a long time received deposits of various kinds—the demand deposit in the checking account; the savings deposit, usually evidenced by a passbook; and the time deposit with a definite maturity or a fixed period of notice of

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withdrawal, represented by a negotiable or nonnegotiable certificate of deposit, a passbook, or some other written agreement. There is nothing new, unique, or devious about these familiar transactions. The essential feature is not the instrument—its form or maturity or negotiability. Rather it is the capacity of banks as multipurpose financial intermediaries to pay more at this time for funds than the single-purpose institution that is crucial. This is an advantage that may shift as it has in the past, when the housing boom favored the nonbank financial intermediary.

For the first decade and a half after World War II, the growth of commercial banks was outstripped by mutual savings banks and savings and loan associations, the two major competing financial intermediaries. By historical standards banks had more than adequate liquidity in the late 1940's and early 1950's; satisfactory earnings were their main problem. Most of the credit demands of customers were easily met out of such moderate growth in deposits as took place and from the conversion of the more liquid assets held by banks into the loans sought by consumers and by businesses. Ample liquidity also permitted commercial banks to build up their portfolios of tax-exempt securities offered by State and local governments. During this period, interest rates tended to vary with the fluctuations in business activity, but movements were moderate and rate relationships remained relatively stable.

In the past 5 years, however, we have witnessed the appearance of new elements on the economic scene. In the first place, our international balance-of-payments position became a major factor in economic policy decisions as our payments deficit persisted. A second and even more important factor has been the duration and strength of our current economic expansion. Domestic credit demands have increased in intensity and have been complicated by our international commitments. More and more corporations have sought external sources of financing to supplement previously adequate internal flows of funds. Consumers likewise have increased their demands for credit to finance purchases of "big ticket" items such as automobiles, housing, and the like. Thus banks have been able to find profitable business opportunities notwithstanding the higher cost of new money.

Commercial banks responded to these demands for credit by seeking new sources of loanable funds to expand their lending activities. Bank entry into term lending on a large scale and increased participation in mortgage and consumer financing further increased the money requirements of banks. In these circumstances, it was natural for banks to use the credit instruments that seemed best adapted to the preferences of those with money to invest.

In this period of expansion in bank lending activities, one of the principal instruments has been the large-denomination negotiable certificate of deposit. Previously, these banks had been reluctant to offer an interest-bearing deposit to corporations for fear that non-interest-bearing deposits might merely be converted into interest-bearing accounts.

The need for banks to tap new sources of loanable funds coincided with a growing volume of large corporate balances available for short-term investment. A large part of these balances were being invested in commercial paper and in the U.S. Treasury bill market—much of it doubtless withdrawn from bank deposit accounts yielding no return to the holder.

The introduction of the large certificates succeeded in attracting a significant share of these corporate balances to banks. It is difficult to tell whether these balances will continue to be a major contributor to deposit growth in banks at the rate of the past several years, but there is increasing evidence that the growth in these investable balances has slowed down. The financial community has adjusted satisfactorily to this new money-market instrument. Reversal of this evolutionary process would be of dubious value to the economy as well as quite difficult.

Lest we forget, permit me to reemphasize that certificates of deposit are not just a money-market instrument. Banks have offered certificates of deposit and other forms of time deposits to individual savers for many years. In some parts of the country, as in the Midwest, they have had a long and important history. They offered a way for banks to differentiate the services they offered customers; they were an alternative to customer savings accounts rather than a money-market asset.

A survey of time and savings deposits conducted by the Federal Reserve in late 1965 and early 1966 showed that almost half of the member banks issued savings certificates. Almost three-fifths of the total was concentrated in the three midwestern Federal Reserve districts of Chicago, St. Louis, and Min-

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neapolis. It is difficult, therefore, to see any justification for outlawing a deposit contract that has long been used by banks and is fully understood by depositors.

Successive increases in the interest rate ceilings of the Federal Reserve System and the Federal Deposit Insurance Corporation have played a part in the ability of banks to attract all forms of time and savings deposits. The increase in rate ceilings at the beginning of 1962 made banks competitive with nonbank financial institutions in this area. A differentiation of the ceiling rate on time deposits from that on savings deposits was introduced in November 1964, primarily for balance-of-payments reasons. At first this differential was only one-half of 1 percent and had only a moderate impact on money flows within the domestic economy.

In early December 1965 this differential was widened to 1½ percentage points. At that time, the impact of the action on particular segments of the market was difficult to foretell because of the increasing complexity of financial markets. The movement of rates toward the ceiling by banks in the leading financial centers was more rapid than had been anticipated. A differential of this size tends to provide a very strong inducement for banks to develop new instruments to attract funds. Since that time, we have seen a wide variety of deposit contracts spring into use, such as savings or investment certificates and savings bonds. The contracts themselves, however, are not really new—after all, the U.S. Treasury invented the savings bond long ago. But banks have entered actively into the market for small savings that are responsive to interest rate spreads.

Restrictions designed to influence the market for financial savings are liable to have unintended results. In any event, we have too little knowledge about the patterns traced by funds as they move about our economy to be able to predict with any degree of accuracy responses that banks may make to restrictive action. The FDIC and the Federal Reserve are now conducting surveys of interest rates and other terms offered on time and savings deposits in banks. From the surveys we hope to gain more information on the types of instruments being offered, the number of banks in the market, the dollar amounts of the various types outstanding, rates, and other terms. Thus, we expect to obtain a better insight into bank responses to changes in interest rate ceilings.

Nevertheless, the limited evidence available tends to indicate that smaller banks would be disadvantaged as opposed to the larger institutions if restrictions were placed on time deposit facilities offered by banks. A Federal Reserve survey conducted early this year showed that among member banks savings certificates were offered mainly by small institutions and that small banks accounted for two-thirds of other nonnegotiable time certificates of deposit.

Small time and savings deposits—as measured by accounts of $10,000 or less—comprise, moreover, a much larger proportion of the total deposits of the 12,000 small banks in the Nation than of the large banks. According to the FDIC's most recent survey of deposit structure, banks with less than $25 million in deposits have almost three-fourths of their savings and time deposits in accounts of $10,000 or less. Comparable figures for larger banks are 60 percent for banks in the $25–$500 million deposit group and 38 percent for banks with $500 million or more in deposits. Small banks are essentially confined to local and regional markets and thus to the smaller savings market. As the accounts become larger, there is an incentive for the holder to shift his funds to a larger bank. The inducement increases if there is also an interest incentive.

These figures illustrate some of the problems that would be posed for small banks if restrictions were placed on their ability to compete for deposits. Not only would the small bank be disadvantaged in relation to larger banks but its competitive position in relation to nonbank financial institutions would be weakened.

Even if the same interest rate limitations, for example, were applicable to both banks and savings and loan institutions, large banks would maintain their advantage. Deposit insurance and share account insurance give smaller banks and savings and loan institutions equal drawing power with large banks only up to the insurance limit ($10,000 at the present time), given the same interest rates. Because size tends to be equated with strength, funds above the limit would be attracted to the larger multipurpose institutions or into higher yielding investment outlets.

I should like to summarize the Corporation's position as follows: Recently the various forms of time deposits with higher permissible rates of interest designed to attract the small saver have had an undeniable impact on the flow of funds into banks—an impact that has also affected other savings institutions.

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To be sure it is difficult to gage the magnitude of the impact. Many other economic forces have been influencing the flow of funds—the strength of the current business expansion and capital spending, to mention only two. Beyond question, changing economic conditions have contributed importantly to the development of these new patterns in the flow of savings. Now as a general principle I think it is unwise to tamper with economic developments that evolve out of the natural operation of market forces. Nevertheless, as agents of responsible government, it is incumbent upon us to facilitate economic adjustments in transition periods so that we may realize desirable objectives with as little friction as possible.

Time as well as savings deposit contracts have long been useful in our banking structure, and it would be a serious error to deny to banks access to any particular segment of the savings market. The negotiable form of bank obligations yielding a return is, in addition, essential to the efficient functioning of the financial markets. No constructive purpose would be served by altering or limiting deposit contracts when the principal factor responsible for our current concern may be the rate pattern and structural changes in the financial community rather than the form of contract.

Actions to modify the rate pattern should therefore be undertaken with caution because they may have unforeseen and unfortunate repercussions. Their impact could be highly uneven among geographic regions or among different types of financial institutions and markets. Small banks and other small financial intermediaries may discover that they are being hurt by measures taken to deal with another problem. These are just some of the considerations that the supervisory authorities of financial institutions must take into account in weighing the various courses of action open to them.

Admittedly serious imbalances could develop in our economy from the diverse effect on institutions of varying interest rates and this can both complicate as well as prolong the adjustment period. Moreover, burdens imposed on institutions and individuals in the course of the transitional period may be unnecessarily heavy. Accordingly, I am convinced that consideration should be given by your committee to a program that will provide the machinery necessary to avoid or mitigate disadvantage to individuals or institutions.

In the deliberations of your committee I commend for thoughtful study a plan along the lines proposed by Henry H. Fowler. the Secretary of the Treasury, as a promising basis for temporary relief in this troublesome situation. The proposal for differential interest-rate ceilings with higher interest rates permissible on a bank deposit contract in excess of a specified dollar amount is good. However, to be realistic and workable the cutoff point should be quite high—in my judgment at least $100,000. It is a fact that permitting higher rates on big deposits will give large banks a competitive advantage over small banks whatever the cutoff point may be; but the higher the cutoff the less will be the impact on small banks. However, this would only be true if interest-rate differentials were not large enough to stimulate a flow of deposits either between categories of banks or between banks and alternative investment opportunities in the market. Furthermore, the impact on small banks would be lessened if the duration of the proposal also was limited to 1 year to allow time for the necessary market adjustments.

The setting of a ceiling rate—at whatever dollar amount—has the disadvantage of encouraging brokers to reenter the market for bank deposits. Such brokerage activity cannot be effectively regulated under our current interest-rate authority. The enforceability of interest-rate ceilings should be strengthened by the enactment of legislation we have proposed to accomplish this object.

But quite apart from the details of the proposal by Secretary Fowler as I read the testimony of the witnesses who have appeared before your committee, I am convinced that the first and essential feature of any program should be maximum flexibility in its operation. With flexibility, it will be easier to promote adjustments suited to changing circumstances and thus avoid the constraints of a statutory enactment that would build rigidities into our economy and also encourage the development of circuitous channels for avoidance. With maximum flexibility, it will be possible to rely as much as possible upon the interaction of economic forces in the marketplace. Flexibility will permit action by Federal authority when action is necessary—and only to the extent that it is necessary. Furthermore, it will permit relaxation of controls in favor of the operation of market forces more rapidly.

In achieving the necessary degree of flexibility demanded by the present situation, I think that it would be desirable to provide a statutory basis for

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fixing interest rates "straight across the board". This means that interest-rate ceilings should be established both for banks and for nonbank financial institutions on some consistent basis. To bring this about it would be necessary to lodge the authority for establishing such rates in a single Federal agency or parallel authority with effective coordination such as provided in sections 4, 5, and 6 of the proposed Federal Deposit and Share Account Insurance Act of 1965 sponsored by the administration (S. 3561).

As matters now stand, imbalances can emerge because interest rate controls are not applicable to all financial institutions. Establishment of authority over interest-rate levels with an agency or agencies, such as mentioned above, should carry with it the power to differentiate rates with respect to the class or type of obligation issued by the financial institution. To illustrate, this power would permit the establishment of a 4-percent rate of interest on passbook savings accounts of commercial banks and similar obligations in competing institutions such as savings and loan associations and mutual savings banks. This power would also permit establishment of a higher rate on time funds and on various additional types of obligations—for example, large certificates of deposit that are essentially money-market instruments and so recognized in the financial community. For instance, interest-rate ceilings could permit differentiation between CD's in denominations above and below $100,000.

Taken in its entirety, my proposal with respect to the problem of interest-rate ceilings could make use of any classification of credit instrument to handle any situation that arises with maximum flexibility. This solution would provide the degree of discretionary control needed for situations such as the one we are currently facing.

I commend this approach to your committee for its thoughful consideration. The proposal is essentially a simple one—broad powers to regulate interest rates flexibly to deal with specific troublesome situations—such regulatory authority to be accorded sufficient power to discharge its responsibilities. This approach, in my opinion, will ease transitional periods such as the one in which we now find ourselves and can be used to forestall the emergence of similar situations in the future. It makes possible as much or as little control as the situation demands within broad guidelines.

We have been advised by the Bureau of the Budget that there is no objection from the standpoint of the administration's programs to the submission of this statement.

Mrs. SULLIVAN. Mr. Kirchner.

STATEMENT OF ARCHIE K. DAVIS, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, AS PRESENTED BY W. G. KIRCHNER, PRESIDENT, RICHFIELD BANK & TRUST CO., RICHFIELD, MINN.; ACCOMPANIED BY CARTER H. GOLEMBE, DEPUTY MANAGER, AMERICAN BANKERS ASSOCIATION

Mr. KIRCHNER. Madam Chairman and members of the committee, I would like very much to have brought the entire message to you, but I realize the pressures of time and particularly I would like to have done so because I speak for Archie Davis in presenting a written statement who has prepared the documentary material to present to the ABA viewpoint. However, I will paraphrase it to the best of my ability since that is your wish and I would very much like to add a personal comment of my own at the conclusion of paraphrasing Mr. Davis' remarks, if I might be allowed to do that.

Mrs. SULLIVAN. All right.

Mr. KIRCHNER. My name is William Kirchner and I am president of the Richfield Bank & Trust Co. of Richfield, Minn., and a member of the Bank Management Committee of the ABA.

Accompanying me is Mr. Carter Golembe, deputy manager in the Washington office of the ABA. I am here today to present the state-

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ment of Archie Davis, president of our association and it was prepared, keeping in mind both bills, H.R. 14026 and H.R. 14422.

As you may recall, Mr. Davis was originally scheduled and was in Washington to appear before the committee on May 19, but the committee schedule was changed at the last minute. Because of a prior commitment, Mr. Davis could not be in Washington today and he has asked me to appear in his place.

This is the statement which Mr. Davis has prepared to represent the position of the American Bankers Association.

We are grateful for this opportunity to present the views of the American Bankers Association on H.R. 14026, a bill which you have introduced to prohibit commercial bank issuance of negotiable certificates of deposit and other negotiable obligations, and H.R. 14422, a bill introduced by Representative Ottinger, of New York, which would prohibit acceptance by any insured bank of any time deposits less than $15,000.

We must respectfully express the strong opposition of the American Bankers Association to both of these bills. It is our view that enactment of H.R. 14026 could lead to a devastating crisis in the Nation's financial markets. Equally damaging would be H.R. 14422, although in this instance the harm would be done to thousands of small commercial banks throughout the country as well as to their depositors, borrowers, and economies of their respective communities.

Since your bill and that introduced by Representative Ottinger are directed primarly at the certificate of deposit, it may be helpful to review briefly the history of this instrument. First, it is exceedingly important to keep in mind that the certificate of deposit is an old and traditional banking instrument, probably dating back to the beginnings of banking in this country. Indeed, in some areas of the country—particularly rural communities—the certificate of deposit is used in preference to a passbook savings account. To illustrate the importance of these certificates, in 1928 (the earliest date for which information is readily available), approximately one-seventh of the total savings and time deposits of individuals, partnerships, and corporations in Federal Reserve member banks consisted of certificates of deposit. Doubtless the percentage was even higher for banks which were not members of the Federal Reserve System at that time. In 1957, a special survey by the Federal Deposit Insurance Corporation revealed that certificates of deposit in insured commercial banks exceeded $3 billion, while in 1960 a similar survey by the FDIC showed that these certificates accounted for $4.6 billion of savings and time deposits. You will note that the dates I have given precede the entry of large banks into the CD market, through the use of the marketable, negotiable instrument, so that it can be assumed that the bulk of the amounts I have mentioned involved certificates of deposit issued by small country banks.

Let me turn now to the specific bills which you are considering. It is our considered judgment, Madam Chairman, that enactment of H.R. 14026 would severely impede the orderly functioning of the Nation's financial markets. The immediate cessation of issuance of negotiable certificates of deposit—which we assume refers to the large marketable issues described earlier—would subject financial markets to the severest of pressures. As the certificates matured and could

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not be renewed, banks would be forced to attempt to shift them to nonnegotiable form—perhaps with partial but surely much less than full success—and a scramble for liquidity would begin. No doubt the Federal Reserve banks could, by purchasing large amounts of Government securities and perhaps lowering member bank reserve requirements, mitigate this pressure, but there is little chance that they could offset its full impact and it would be impossible to make certain that the funds so provided would find their way to the institutions where most needed.

Just as H.R. 14026 would have a severe impact on the money market banks and, through them, on the economy, Mr. Ottinger's bill, H.R. 14422, would have an equally severe impact on thousands of small banks and small communities across the country.

Because of the $15,000 cutoff, it is clear that H.R. 14422 would have little effect on the issuance of negotiable certificates of deposit by large banks in financial centers, but it would mean disaster for the main-street bank in this country. As I have already noted, negotiable certificates of deposit are issued in denominations typically far larger than $15,000, whereas the nonnegotiable certificate is issued in denominations usually much less than $15,000. The importance of these small certificates to country banks can be illustrated by data from an ABA survey of a large sample of banks issuing certificates as of the end of 1965. At that time, 47 percent of banks with less than $10 million in deposits had more than half of their savings and time accounts in certificates of deposit.

Let us consider for a moment what the effects might be of this bill on small banks. Assuming no change in the ceiling on passbook savings, many of these banks would find that they would lose a large portion of their savings and time deposits and, of course, would be unable to attract additional funds. Thus, only a year or so after these small banks have managed to become competitive with savings and loan associations, after many decades of being unable to compete with these institutions, the clock would be set back.

Second, since many of the small banks which rely on the nonnegotiable certificate of deposit are in one-bank communities with no other competing financial institutions, funds would undoubtedly leave small communities for other areas where more attractive rates are offered. Possibly it could be argued that these funds would be largely captured by savings and loan associations—particularly those which aggressively solicit savers' funds through the mail by offering high dividend rates—and it might even be argued further that such a flow would be of significance to residential construction. But one should not forget that, as important as residential construction is to the health of the economy, the consumer, farm, business, and municipal activities financed by commercial banks are also of crucial importance. Any action that sharply reduced the ability of commercial banks—particularly main-street banks—to meet the needs of their customers could have an even greater and quicker impact on the economy than a contraction in the flow of mortgage credit.

Further, we should also recall that commercial banks have been increasingly aggressive lenders in the home mortgage field in recent years. In the 10 years from the end of 1955 to the end of 1965, residential real estate loans held by commercial banks increased by 105

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percent, or over $16 billion. And during the single year 1965, the increase was in excess of $3 billion, or 12 percent. In addition, of course, commercial banks make construction loans, and also originate a substantial volume of residential mortgage loans which are then sold to other investors such as life insurance companies. Consequently, the shift of a dollar from a savings and loan association to a commercial bank does not necessarily mean that the dollar will be lost to the housing market and, even if it is, it may go to finance a project which will provide a vital service to the community.

As I have indicated earlier, while we see nothing wrong with legitimate and healthy competition for savings among all financial institutions, nevertheless we recognize the possibility of the kind of unbridled competition which can be destructive to institutions and to the economy. To draft legislation which will on the one hand encourage healthy competition and on the other hand guard against unsound competition is, indeed, a delicate task. Such legislation should be based on an authoritative body of precise information, and should be drafted in accordance with three important principles:

1. It should not impede the orderly functioning of the Nation's financial markets.

2. It should provide for equal treatment of the industries that compete for the public's savings.

3. It should provide for orderly and efficient administration of the statutes by the appropriate Federal authorities.

The third principle which we mentioned was concerned with orderly and efficient administration of the statutes. There seems to be little question that if regulation is to be fully effective, the authority of the Federal agencies must be more flexible and selective. Accordingly, we recommend that in its supervision of rates the Federal Reserve be given sufficient authority to distinguish between types of depositors and amounts involved.

I should like to conclude this statement with several observations on a legislative proposal made by Secretary Fowler on May 19 in testimony before this committee. You will recall that the Secretary recommended that the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation be provided with authority, for 2 years, to institute different rate ceilings for that portion of time deposits up to the maximum amount which may be covered by Government insurance. The suggested ceilings were 5 percent for certificates of deposit of less than $10,000, and 5½ percent for certificates over that amount. In making this recommendation the Secretary made it clear that he regarded this as a temporary measure which would be useful in a transition period.

Obviously, Secretary Fowler's proposal is much preferable to H.R. 14422, since it would permit banks to continue to issue smaller denomination certificates of deposit. From what we know of the rates now being paid in many parts of the country it would appear that the proposal is workable.

As we have already pointed out, the American Bankers Association stands ready to support measures which will prevent the kind of destructive competition which can damage the economy. On the other hand, it must be recognized that the matter of savings competition is particularly complex, and that much of our present information is

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based on partial reports. Therefore, we would strongly urge that before any action is taken by this committee it examine closely the survey data which the Federal banking agencies should make available shortly.

Should you conclude that emergency action is needed—even prior to the receipt of this information—then we think it is important that the committee make it clear to the Federal Reserve and to the FDIC that they are not tied, directly or indirectly, to a specific set of rate ceilings. The financial climate is changing so rapidly that it would be unwise to introduce inflexible rules at this time, particularly in the absence of complete data. Also, we would strongly urge that the committee make it clear to the regulatory authorities that the guiding principle underlying the establishment of ceilings should not be to protect the competitive position of savings and loan associations or any other industry but, rather, should be the maintenance of a sound and strong financial system, within the framework of which all industries can compete on an equal basis.

That closes Mr. Davis' statement and I would like to add a comment of my own, if I might.

Mrs. SULLIVAN. You may, Mr. Kirchner.

Mr. KIRCHNER. I am president of a small bank located in a community of 45,000. My bank has issued certificates of deposit from the day it opened in 1947 and we depend on this source of funds for a significant portion of our savings and deposits.

Our most recent statement shows that approximately 20 percent of our total savings and time deposits consist of certificates of deposit and all but eight of these certificates are issued in amounts of less than $15,000. I speak for many other small banks as well as my own when I say we feel that the passage of any legislation which would decrease deposits would be ruinous to us and to the small communities of the Nation.

Any of the proposals which you are considering seem to be calculated to reduce the competitive position of the small banks resulting in curtailment of our home lending and small business lending activities. Many of these proposals would provide for inflexible restrictions which cannot be quickly changed in the event of financial developments which we cannot foresee.

This morning at 5 o'clock I added a few words and I would like to give these to you, with the same intensity that I felt at 5 this morning.

I am here because a number of my small bank friends are horribly worried that you may take hurried action here which will bring the small, rural bank to its knees. There are 10,000 to 12,000 of these banks serving the little towns and crossroads of our Nation. They are located in cities, towns of 500 population, 1,000 population, 10,000 or 20,000 and more. They are in Georgia, the Dakotas, Kansas, Montana, in your State, and in every other State of our country. These small banks are struggling to meet high costs of operation and to give service to their local citizens and neighbors.

Many of these towns have only the small bank to provide financial service. There is no savings and loan association, mutual savings bank, or any other kind of lending institution. These banks have always issued certificates of deposit. The small institutions need

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every possible dollar of deposit of any type to meet the financial needs of the communities they serve. Certificates of deposit have been issued by banks as far back as my memory extends. The first bank for which I worked, in Sioux City, Iowa, had three employees on the total staff, when I joined to make it four. That was in 1934. I know we issued certificates of deposit because farm livestock feeders put money in certificates, when they sold cattle and were not ready to buy more cattle at that season of the year or until the market changed. They borrowed against these certificates before maturity and they were negotiable to the extent that they could be pledged for collateral. They were not marketable because no one wanted to buy them.

The large savings and loan institutions have been advertising by mail to small towns and cities. Whether 50 or 100 or 1,000 miles away, they were advertising to seek deposits at rates very difficult for that small bank to meet.

These moneys were at times successfully drawn into the large cities, into savings and loans that were ready to provide financing for suburban and urban housing needs. However, the same institutions were and are very reluctant, or would refuse, to make a loan for housing, farm acquisition or small business in that same small town from whence came the funds.

I plead with you gentlemen, to think long and hard before you set up rigid statutory regulations which will take away the certificates from the small banking institutions in thousands of communities over the country.

If you must place limitations on that type of bank deposit, it is mandatory that there be similar restrictions placed on competitive financial institutions. Without such regulations applied to all, you will destroy many smalltown banking institutions already hard pressed to meet local needs.

Mrs. SULLIVAN. Thank you, Mr. Kirchner.

(The complete statement of Mr. Davis follows:)

STATEMENT OF ARCHIE K. DAVIS ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

We are grateful for this opportunity to present the views of the American Bankers Association on H.R. 14026, a bill which you have introduced to prohibit commercial bank issuance of negotiable certificates of deposit and other negotiable obligations, and H.R. 14422, a bill introduced by Representative Ottinger, of New York, which would prohibit acceptance by any insured bank of any time deposit less than $15,000.

We must respectfully express the strong opposition of the American Bankers Association to both of these bills. It is our view that enactment of H.R. 14026 could lead to a devastating crisis in the Nation's financial markets. Equally damaging would be H.R. 14422, although in this instance the harm would be done to thousands of small commercial banks throughout the country as well as to their depositors, borrowers, and economies of their respective communities.

I should like to begin by making a few general comments with respect to the factors which underly recent developments in financial markets. It should be strongly emphasized that increases in rates paid on certificates of deposit, as well as increases in interest rates generally, are not the result of individual actions taken by commercial banks or by other financial institutions. The basic explanation for this development is simply that we have a burgeoning economy, straining against its productive capacity, coupled with an effort by monetary authorities to guard against inflation. Under such circumstances interest rates must rise, just as they have in all previous periods under similar circumstances. I mention this point so that we do not fall into the trap of mistaking effect for cause.

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The concern with which specialized savings institutions view this development is attributable to a single, all-important fact; commercial bank earnings enable banks today to offer attractive rates for savings. Not only are banks capable of paying higher rates, but the regulatory authorities are permitting them to do so, at least with respect to certain types of obligations. For many years this was not the case—and the thrift institutions prospered accordingly.

Given the present state of the economy, the ability of commercial banks to compete for savings with one another and with nonbank institutions, and the predictable reactions of the thrift institutions, there is no question that we may see the appearance of unsound competitive practices. To the extent that competition for savings does become destructive the American Bankers Association will support reasonable attempts to restrain such practices. Nevertheless, as I have already indicated, we do not believe that the measures proposed in either of the bills before you today will achieve this objective.

Since your bill and that introduced by Representative Ottinger are directed primarily at the certificate of deposit, it may be helpful to review briefly the history of this instrument. First, it is exceedingly important to keep in mind that the certificate of deposit is an old and traditional banking instrument, probably dating back to the beginnings of banking in this country. Indeed, in some areas of the country—particularly rural communities—the certificate of deposit is used in preference to a passbook savings account. To illustrate the importance of these certificates, in 1928 (the earliest date for which information is readily available), approximately one-seventh of the total savings and time deposits of individuals, partnerships, and corporations in Federal Reserve member banks consisted of certificates of deposit. Doubtless the percentage was even higher for banks which were not members of the Federal Reserve System at that time. In 1957, a special survey by the Federal Deposit Insurance Corporation revealed that certificates of deposit in insured commercial banks exceeded $3 billion, while in 1960 a similar survey by the FDIC showed that these certificates accounted for $4.6 billion of savings and time deposits. You will note that the dates I have given precede the entry of large banks into the CD market, through the use of the marketable, negotiable instrument, so that it can be assumed that the bulk of the amounts I have mentioned involved certificates of deposit issued by small country banks.

In 1961. money-market banks began to issue and actively promote the negotiable certificate of deposit. These certificates are issued in large denominations—typically in units of $100,000 or more. Their appeal to holders of idle balances. particularly corporate treasurers. combined with the development of an organized market, help account for their rapid acceptance and growth since that time. Today, the total of negotiable certificates of deposit outstanding exceeds $17 billion.

At this point it should be noted that the term "negotiable" can be misleading, since it is undoubtedly the case that some of the smaller certificates issued for many years by country banks are also negotiable, in the sense that they can be sold or transferred. However, negotiability is not an essential characteristic of these certificates. Probably the most meaningful distinction between the two types of certificates is that the so-called nonnegotiable certificate is one of small denomination—say $100 to $5,000—for which there is no organized secondary market, whereas the so-called negotiable certificate is usually of large denomination, for which there is such a secondary market. While I shall use the terms "negotiable" and "nonnegotiable" in this statement, they should be understood to be used in the context I have just described.

The reason for vigorous promotion by larger banks of negotiable certificates as distinguished from the nonnegotiable variety—was that demand deposits in the larger financial centers had been growing relatively slowly for some time, and corporate treasurers were becoming increasingly reluctant to leave temporarily idle balances in non-interest-bearing demand accounts. Commercial banks in the larger cities needed an obligation comparable to prime commercial paper or bills so that they could compete more effectively for time funds and thus meet the credit demands of their areas and of the economy as a whole.

I must stress the fact that, basically, there is nothing to be criticized in this development. On the contrary, there is no doubt in my mind that, on balance, the economy has benefited. A portion of the corporate and other balances which previously had gone into specialized instruments or institutions have, since 1961, gone into commercial banks and from there have flowed out to the sectors of the economy most in need of credit. The marketplace, through the time-honored

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mechanism of price (here, interest), is efficiently channeling funds into their most productive uses. Unless one is prepared to argue that these funds would be used more productively in, for example, the stock market, the bill market, or the commercial paper market, then it must be conceded that commercial banks—as multipurpose lenders occupying a pivotal position in the economy—have introduced a needed element of flexibility into credit allocation.

Obviously, if used unwisely the negotiable certificate of deposit can cause difficulties for banks. Similarly, the nonnegotiable certificate of deposit can cause difficulty as can any other obligation of commercial banks. And I might point out that if one is concerned with the volatility of deposits, the bulk of commercial bank deposits still consists of those which are held on demand and thus are, potentially, more volatile than any other type of deposit.

Let me turn now to the specific bills which you are considering. It is our considered judgment, Mr. Chairman, that enactment of your bill, H.R. 14026, would severely impede the orderly functioning of the Nation's financial markets. The immediate cessation of issuance of negotiable certificates of deposit—which we assume refers to the large marketable issue described earlier—would subject financial markets to the severest of pressures. As the certificates matured and could not be renewed, banks would be forced to attempt to shift them to nonnegotiable form—perhaps with partial but surely much less than full success—and a scramble for liquidity would begin. No doubt the Federal Reserve banks could, by purchasing large amounts of Government securities and perhaps lowering member bank reserve requirements, mitigate this pressure, but there is little chance that they could offset its full impact and it would be impossible to make certain that the funds so provided would find their way to the institutions where most needed.

It is important to note that, although the commercial banks would bear the first brunt of this type of liquidity crisis, the impact would by no means stop there. Banks customers—including savings and loan associations and other financial institutions—would probably find their credit lines sharply reduced. Interest rates would probably rise sharply. Unless offset by massive, inflationary additions to bank reserves, enactment of H.R. 14026 could conceivably result in such credit stringency that the economy would be tipped into recession.

Further, it is difficult to understand how the economy would benefit even if, by some remote chance, there could be an orderly liquidation of the $17 billion of negotiable certificates now outstanding. These certificates are, as you know, issued in very large denominations. These are not funds which usually go to savings and loan associations or similar competitors. But to the extent that commercial banks were able to substitute nonnegotiable issues—which undoubtedly would have to be of smaller denomination than the typical negotiable certificate—the competitive pressure on savings and loan associations and other bank competitors would be greatly intensified. If, on the other hand, banks are unable to retain the bulk of the funds now represented by negotiable certificates, the balances would flow elsewhere—to the stock market perhaps, or to the bill market, or to the commercial paper market. Equally significant, they would be pulled out of the productive uses to which they are presently being put. No one can predict what the net effect would be, but the possibilities are almost infinite. Thus, for example, if the flow is to the commercial paper market and out of the municipal securities market (as banks liquidate their holdings of such securities) one would expect a decline in commercial paper rates and a corresponding increase in the borrowing costs of small communities throughout the Nation. As I say, the possibilities are too numerous to consider; but the basic point is that there is no evidence that the economy is being harmed by the use which is now being made of these funds by commercial banks, or that the economy would be benefited by the use which others would make of them.

Just as H.R. 14026 would have a severe impact on the money-market banks and, through them, on the economy, Mr. Ottinger's bill, H.R. 14422, would have an equally severe impact on thousands of small banks and small communities across the country. I might remind this committee that some 10,000 commercial banks, comprising about 75 percent of the entire number, have deposits of less than $10 million and are, by and large, smalltown banks. It would be difficult to tell which of the two would be more harmful; the judgment on that would depend on the importance which you place on the role which small communities play in our economy as compared with the few large financial centers.

Although H.R. 14422 would prohibit any insured bank from accepting a time deposit in an amount less than $15,000—and makes no mention of a certificate of

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deposit—nevertheless we assume that it is the smaller sized certificate of deposit at which the bill is aimed primarily. Because of the $15,000 cutoff, it is clear that H.R. 14422 would have little effect on the issuance of negotiable certificates of deposit by large banks in financial centers, but it would mean disaster for the main-street bank in this country. As I have already noted, negotiable certificates of deposit are issued in denominations typically far larger than $15,000, whereas the nonnegotiable certificate is issued in denominations usually much less than $15,000. The importance of these small certificates to country banks can be illustrated by data from an ABA survey of a large sample of banks issuing certificates as of the end of 1965. At that time, 47 percent of banks with less than $10 million in deposits had more than half of their savings and time accounts in certificates of deposit.

The probability—indeed, certainty—of a severe impact on small banks and on their communities will, we believe, become evident when the surveys now underway by the Federal Reserve and the Federal Deposit Insurance Corporation become available. We also believe that these surveys will show that small banks throughout the Nation have been able to hold and attract deposits needed for lending only by issuing small-denomination certificates and by paying between 4 and 5 percent on these certificates. In this connection, it must be emphasized that certificates of deposit are very similar to regular savings accounts for these banks and for their depositors, so that any limitation such as that proposed in H.R. 14422 would simply prevent these banks from conducting the kind of savings business which has been conducted for generations.

Let us consider for a moment what the effects might be of this bill on small banks. Assuming no change in the ceiling on passbook savings, many of these banks would find that they would lose a large portion of their savings and time deposits and, of course, would be unable to attract additional funds. Thus, only a year or so after these small banks have managed to become competitive with savings and loan associations, after many decades of being unable to compete with these institutions, the clock would be set back.

Second, since many of the small banks which rely on the nonnegotiable certificate of deposit are in one-bank communities with no other competing financial institutions, funds would undoubtedly leave small communities for other areas where more attractive rates are offered. Possibly it could be argued that these funds would be largely captured by savings and loan associations—particularly those which aggressively solicit savers' funds through the mail by offering high dividend rates—and it might even be argued further that such a flow would be of significance to residential construction. But one should not forget that, as important as residential construction is to the health of the economy, the consumer, farm business, and municipal activities financed by commercial banks are also of crucial importance. Any action that sharply reduced the ability of commercial banks—particularly main-street banks—to meet the needs of their customers could have an even greater and quicker impact on the economy than a contraction in the flow of mortgage credit.

Further, we should also recall that commercial banks have been increasingly aggressive lenders in the home mortgage field in recent years. In the 10 years from the end of 1955 to the end of 1965, residential real estate loans held by commercial banks increased by 105 percent, or over $16 billion. And during the single year 1965, the increase was in excess of $3 billion, or 12 percent. In addition, of course, commercial banks make construction loans, and also originate a substantial volume of residential mortgage loans which are then sold to other investors such as life insurance companies. Consequently, the shift of a dollar from a savings and loan association to a commercial bank does not necessarily mean that the dollar will be lost to the housing market and, even if it is, it may go to finance a project which will provide a vital service to the community.

I might note in passing that savings and loan associations are also requesting legislation which would permit them to channel their funds out of mortgage loans into other loans or investments—a request which surely should be set aside so long as this industry is expressing its concern to your committee that it does not have sufficient funds to service mortgage customers. The American Bankers Association supports, on the other hand, legislation which will amend section 24 of the National Banking Act, to ease restrictions on national bank loans on residential property and thereby increase the effectiveness of national banks as mortgage lenders.

The third, and possibly most realistic, assessment of the effect of passage of H.R. 14422 would be the exertion of intense pressure from all parts of the coun-

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try to raise the present 4-percent ceiling on passbook savings. Even this would not be a satisfactory solution since, under present regulations, banks cannot accept deposits of corporations in their regular (passbook) savings accounts, though savings and loan associations and mutual savings banks can do so. But in any event, an increase in the passbook savings rate would be absolutely essential to country banks which have been paying somewhat higher rates on certificates of deposit and which depend on certificates for a large percentage of their savings and time deposits. It is doubtful that the Federal banking agencies or, for that matter, the Congress would stand by and see thousands of small commercial banks forced to liquidate assets as their traditional and regular savings business is choked off. Thus, the ultimate result of H.R. 14422 would be simply to increase rates on passbook savings and to force many country banks to go through the inconvenience of adopting a new (for them) type of savings business.

As I have indicated earlier, while we see nothing wrong with legitimate and healthy competition for savings among all financial institutions, nevertheless we recognize the possibility of the kind of unbridled competition which can be destructive to institutions and to the economy. To draft legislation which will on the one hand encourage healthy competition and on the other hand guard against unsound competition is, indeed, a delicate task. Such legislation should be based on an authoritative body of precise information, and should be drafted in accordance with three important principles:

1. It should not impede the orderly functioning of the Nation's financial markets.
2. It should provide for equal treatment of the industries that compete for the public's savings.
3. It should provide for orderly and efficient administration of the statutes by the appropriate Federal authorities.

Obviously, the use of the certificate of deposit is at the heart of the current concern over the possible development of unsound competitive practices. Accordingly, if legislation is to be drafted in this area, it should be particularly helpful to this committee to have before it the results of the studies presently being conducted by the Federal Reserve and the FDIC. We understand that this material will be available in several weeks.

Several comments should be made on the principles which we have just set forth. It seems clear to us that legislation which will result in a drastic interference with the functioning of financial markets must be avoided, however worthy the objectives. As we have already pointed out, we believe that the two bills before you are seriously deficient in this regard.

With respect to the second principle—competitive equality—it is our belief that if there is to be legislation designed to prevent the development of unsound competitive practices, it should apply across the board to all competing institutions. If the competitive practices of commercial banks are to be further regulated, so must those of its competitor institutions. We therefore strongly recommend that this committee consider carefully the longstanding proposal of the administration to give to the Federal Home Loan Bank Board authority to regulate rates paid by savings and loan associations, and we further recommend that the FDIC be directed to rescind its regulation which presently exempts insured mutual savings banks from rate regulation by that agency.

The third principle which we mentioned was concerned with orderly and efficient administration of the statutes. There seems to be little question that if regulation is to be fully effective, the authority of the Federal agencies must be more flexible and selective. Accordingly, we recommend that in its supervision of rates paid by commercial banks on savings and time deposits, the Federal Reserve be given sufficient authority to distinguish between types of depositors and amounts involved. Also, in order to assure effective administration of any legislation that might be enacted in this area, we strongly suggest that you give favorable consideration to a proposal which I first presented a year ago in testimony before this committee's Subcommittee on Bank Supervision and Insurance. This proposal would assure that one Federal agency would issue regulations on all matters pertaining to interest rates on time and savings deposits as well as definitions of what constitutes a demand or savings deposit. I repeat my recommendation of a year ago: Place in the Board of Governors of the Federal Reserve System full and exclusive jurisdiction over the definition of savings and time deposits, and the enforcement of statutory requirements of payment of interest on time and demand deposits. This is an area which can have important monetary policy implications, but authority is

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presently divided between the Federal Reserve and the Federal Deposit Insurance Corporation.

I should like to conclude this statement with several observations on a legislative proposal made by Secretary Fowler on May 19 in testimony before this committee. You will recall that the Secretary recommended that the Board of Governors of the Federal Reserve and the Federal Deposit Insurance Corporation be provided with authority, for 2 years, to institute different rate ceilings for that portion of time deposits up to the maximum amount which may be covered by Government insurance. The suggested ceilings were 5 percent for certificates of deposit of less than $10,000 and 5½ percent for certificates over that amount. In making this recommendation the Secretary made it clear that he regarded this as a temporary measure, which would be useful in a transition period.

Obviously, Secretary Fowler's proposal is much preferable to H.R. 14422, since it would permit banks to continue to issue smaller denomination certificates of deposit. From what we know of the rates now being paid in many parts of the country it would appear that the proposal is workable.

As we have already pointed out, the American Bankers Association stands ready to support measures which will prevent the kind of destructive competition which can damage the economy. On the other hand, it must be recognized that the matter of savings competition is particularly complex, and that much of our present information is based on partial reports. Therefore, we would strongly urge that before any action is taken by this committee it examine closely the survey data which the Federal banking agencies should make available shortly.

Should you conclude that emergency action is needed—even prior to the receipt of this information—then we think it is important that the committee make it clear to the Federal Reserve and to the FDIC that they are not tied, directly or indirectly, to a specific set of rate ceilings. The financial climate is changing so rapidly that it would be unwise to introduce inflexible rules at this time, particularly in the absence of complete data. Also, we would strongly urge that the committee make it clear to the regulatory authorities that the guiding principle underlying the establishment of ceilings should not be to protect the competitive position of savings and loan associations or any other industry but, rather, should be the maintenance of a sound and strong financial system, within the framework of which all industries can compete on an equal basis.

Mrs. SULLIVAN. In Chairman Patman's opening statement, he said that many small banks have written him, and all of us, that while they have issued time certificates for many years and hope to continue doing so, they deplore the Federal Reserve's drastic increase to 5½ percent interest last December. If they cannot meet the high rates now offered, the money goes to the big city banks. On the other hand, if they do pay the high rates, they are forced to take on high-yield, risky loans with clearly inflationary impact. Therefore, as the chairman said, both the small banks and the thrift institutions may be badly hurt by this rate war and Congress just cannot stand for that.

What is your view of the effect of all of this on smaller banks? Is it harmful to them, particularly as their own passbook savings deposits and demand deposits are converted into high-cost CD's?

Would you like to comment on that, Mr. Randall?

Mr. RANDALL. Yes; indeed I would.

I think I would be in accord with the chairman's statement in this regard. There has been marked impact upon the banks. I believe that the smaller institutions, whether they are banks, mutual savings banks, or savings and loan associations, in large metropolitan areas where they lack the flexibility to adjust, are pretty well caught in a most difficult market transition. Their mutual fortunes are cast together in this regard.

We are concerned and painfully concerned in this regard. I think Mr. Kirchner's personal statement was a very powerful statement

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and I came from a small bank similar to the bank that he was in before I came to Washington and I can feel these pressures that he expressed.

I think there is one lesson to be learned from the movement of regulation Q in December of 1965 and I think if we ignore this lesson we ignore a very meaningful and important part of a dialog that has been going on in this committee and that is, we do not know at any given time what the impact would be of any given regulation or law in this highly sensitive, highly complex market that we are involved in.

We are dealing with several animals, in a way—market animals—if I may make an allusion in this regard. We are dealing with a market of personal savings that primarily is the market that Mr. Kirchner was referring to—small businesses, smaller economic units, personal savings, and we are dealing with a large money market, large corporate idle funds and the international market. Unless we keep these two separated in our thinking and recognize that there are two and recognize that no matter what we do, it is going to have dimensions and impact that we cannot measure at this point. No one thought that the central money market areas would move to the 5½ ceiling with the rapidity that they moved. We all have the benefit of hindsight today—but people looking at this market in December 1965 thought there would be a very minor adjustment necessary to meet some of the pressures that existed. The Federal Reserve as I understand the record felt that, by moving to a full point, instead of a half point, there would be less movement in the market as a result of moving it hopefully to a standby type of situation where just minor adjustments would take place in the market that were necessary. It has far greater impact to create a system that builds in arbitrary rigidness that may have consequences few of us will want to answer for. We think the great plea that we would like to make in FDIC to this committee is to provide the best methods for flexible answers. We are sympathetic to the goals of this committee, and to the problems in this period of time. We are concerned with you.

But if we do it on a rigid basis, we may create far more difficult problems than we are facing today. We make a plea for flexibility in an attempt to solve the problems, because we believe that there is going to be a need for a group of answers as we go through this period of adjustment—not just one, but a group.

Mrs. SULLIVAN. Thank you, Mr. Randall.

Mr. Kirchner, do you have anything else to add to what you said before?

Mr. KIRCHNER. I accept what Mr. Randall has offered and has said well.

I might add this thought, that prior to the adjustment in December, in the smaller communities we were faced with a barrage of advertising. We found the local citizens responding to this and taking money from savings accounts, because they were limited in the interest payments that could be received by the local institution, and were putting them out of the community into distant points.

When the interest change was made in December, many banks faced with real reluctance the additional expense that they would assume by raising interest rates. However, they were aware that it gave them a tool, and that they could not hope to retain the money that

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was generated in that home community, that was needed in that home community, without such a tool. They could keep the funds in their bank to make home loans and to help in that community. And therefore, they raised the rates with some reluctance.

I point this out again to emphasize that unless there is something established that would place comparable restrictions on the various institutions in the financial community, banks will still be in a very difficult spot.

Now, I think that the adjustment in rates was beneficial from the standpoint that it allowed this competitive situation to level off a bit. At the same time, it is a little unfortunate that the rate war has developed and that rates have continued to push higher. I, too, am very much concerned about the state of the economy. In fact, I was concerned for a period of years over the fact that the savings and loans did not provide for any liquidity within their own institutions but were depending on the Home Loan Board for additional funds. Now it seems to me that when things have gotten a little tighter we are faced with the kind of situation that we might have expected and I hope that this committee does not give the medicine to the wrong patient. We should be very careful to reorganize which element of our financial community is sick. Let's treat the sick one and not make the rest sick.

Mrs. SULLIVAN. Thank you. I believe you gentlemen were to respond to some questions put in a letter to you from the chairman dated May 31.

Mr. RANDALL. I believe the instructions on the letter we received yesterday morning asked for answers by tomorrow morning and ours is still in process. We are coordinating with various segments of the administration on this. I do not have clearance on those answers and I would have to decline, other than on those that are answered in my statement. Some of them are referred to in the statement.

Mrs. SULLIVAN. All right, if you will send in the answers.

Mr. RANDALL. We hope to have it ready this afternoon.

Mr. KIRCHNER. The ABA finds itself in a similar position. We have many people over a large part of the country who should be heard from on something of this importance, and an effort is being made to get these views just as rapidly as possible. A letter is now being prepared for the committee. But it would be unreasonable for anyone to speak for the association in answer to those questions now.

Mrs. SULLIVAN. I understand. Thank you.

Mr. Ashley.

Mr. ASHLEY. Mr. Kirchner, I wonder if it would be possible for you to give us the essence of the American Bankers Association's position with respect to what the feelings are and what the committee should do in response to the general problem.

Mr. KIRCHNER. I would like to turn back to the points which are included in Mr. Davis' report.

Mr. ASHLEY. I noted on page 10 the three principles that you set forth, but I wonder if you have anything concrete in the way of proposals.

Mr. KIRCHNER. Let me turn to them.

I think page 11 of Mr. Davis' report adds to what has been given and spells out specific points, to some degree.

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Regarding the first, I think whatever you do should not impede the orderly functioning of the Nation's financial market. We are thinking a little of the kind of a change that was made back in December; that it was a broad change and therefore things changed rather rapidly. We are thinking that any changes made now should not cause further complications because of abruptness and breadth of change. We feel the second is extremely important. If you impose restrictions on savings rates for one part of the financial industry, you penalize them greatly if you allow the others to go without restriction. Only one thing can result; those who are not limited would put their rates just high enough to take away everything from those who are restricted. In a sense this was what was happening before December. So we plead with you, if you set some restrictions and ceilings, to please consider all financial institutions and to try to put them in an equal competitive position. The third principle is that whatever is done should be set up in such a manner that the Federal authorities are able to carry out the policies of the legislation on a discretionary basis.

Mr. TODD. Would the gentleman yield?

Mr. ASHLEY. Yes.

Mr. TODD. In connection with your second point, do I gather you feel it would be satisfactory if the same interest rate ceilings were applied to all financial institutions? That this would be competitive equality?

Mr. KIRCHNER. I would remind the committee I think Mr. Randall touched on this very ably, that we do not really know where all the money has gone. Some of it may have gone in the stock market. Some of it has gone into Treasury securities. Those rates are high. If you place restrictions over all the financial institutions we may find that funds still do not move toward the housing industry, but may move into some of these other areas. As between financial institutions, I would feel that they should be——

Mr. TODD. Now, I feel you are arguing against restrictions rather than against equal restrictions. I was addressing myself specifically to the question of equality. If we impose a restriction, I mean.

Mr. KIRCHNER. I recognize your point and it is well taken. I am in favor of the restrictions being the same overall if we must have restrictions.

Mr. TODD. I thank the gentleman.

Mr. ASHLEY. You commented, Mr. Kirchner, that some of the legislation that had been introduced appears to reduce the competitive position of the small banks. I just want to say that while I am not the author of these proposals, I do not think that this really is the thrust of what is sought to be achieved by the members of the committee. It does lead me to wonder about your statement in conclusion in what you say, essentially, that legislation should not be to protect the competitive position of savings and loan associations or any other industry, but, rather, should be the maintenance of a sound and strong financial system, within the framework of which all industries can compete on an equal basis. The two are not incompatible, are they? Do you not think the competitive position of the industry members in the financial community—do you not think there should be competition within the industry?

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Mr. KIRCHNER. To some degree they are not incompatible. If you provide so much protection for the savings and loan associations, it takes away some of the protection of the other financial institutions. Then you are no longer presenting an equitable position.

Mr. ASHLEY. Precisely, and the reverse side of the coin is true, too, is it not?

Mr. KIRCHNER. Certainly.

Mr. ASHLEY. That is what we are concerned with.

Mr. KIRCHNER. But if you cut off the opportunity for certificates of deposit for small banks so that they lose 10, 20 percent and in many cases even more of their deposits, then they are in a real tough situation.

Mr. ASHLEY. Yes. I was struck by a comment that there would be additional information within the next several weeks. Is that correct? Would you amplify on that, Mr. Randall?

Mr. RANDALL. We did make a special call in conjunction with the Fed. I have copies of it if you would like to have copies for the record. We are trying to determine the impact of shift in the market in types of instruments, methods used by banks, how widespread they are, and in what areas. These calls were made to all of the insured banks and there were 14,500 insured banks in the country. They were to be returned by the 18th of May to the FDIC and to the Federal Reserve. This was a new call. Some of the work had to be redone because this is the type of call that has never been made before and we are finding a lot of errors with the banks because some did not understand what we are trying to do in the less sophisticated centers, perhaps, so we are receiving a lot of invalidated returns. We hope to have it finished by the 15th of June, knowing that the June 30 period is the one that is important in the shifts of funds. We are pushing our staff, we are hiring extra help in order to get this done. We are still hoping that we will at least have some preliminaries, but it would be a little while beyond that before we have the work completely done. The Corporation is in the process of putting the data on a computer and working out several techniques in order to evaluate the returns.

Mr. ASHLEY. I have just one other question.

It is your suggestion, I take it, that the committee might well be advised to await production of this information?

Mr. RANDALL. I think, Mr. Ashley, we have a lot of suspicions, doubts, concerns, and really quite a minimum of knowledge and we hope that we will gain more knowledge.

Mr. ASHLEY. This has been fairly clear.

Mr. RANDALL. I would point out that the FDIC and Federal Reserve were concerned with this even before the hearings started and we made it the basis of a call prior to these committee hearings being started. So we do share and have shared your concern in this important matter.

Mr. ASHLEY. I might say that I was really delighted at the brilliant presentation of Governor Robertson, namely because he had so little basic information during his brilliant presentation before the committee. Very little was indicated where the $17 billion increases come from. Thank you.

Mrs. SULLIVAN. Mr. Fino?

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Mr. FINO. Thank you, Madam Chairman. Mr. Randall, 2 weeks ago the House, as you well know, engaged in 3 days of heated debate on the Participation Sales Act. You will also recall, the vote was a very close one.

Now, regarding this great concern, this deep interest for CD's, do you not think that the sale of participation certificates of FNMA, 5½, 5¾, and possibly 6 percent would soak up investment funds much like the sale of CD's?

Mr. RANDALL. Mr. Fino, we tried to make it plain in our statement that if we, by regulation or by statute, create arbitrary lines that are too far away from what is happening in a free money market environment, that we still will not solve the problems that we are talking about today. If we buy an across-the-board ceiling—place a ceiling on what banks and savings and loans and mutual savings banks can pay on deposits and we have a free market that is so attractive with a higher rate, these funds are going to leave everyone, not one section or another. You can only regulate within certain disciplines of a free market, and I think that this is going to have an influence in the market. It probably will create even more pressures in the money market in the short run, in the transition period, and this again gets back to the point that I believe we should have controls to ease this transition period and cut down the impact as much as possible. Shall we say, lower the frequency of the cycle so that it is not as high, but a lower cycle. We still cannot avoid the disciplines of a free market. These are still going to be the outer limits of where we can move, because if we avoid this, if we try to contain these rates too far down out of reality, the money is going to fly. There are very important economic disciplines that are going to continue to exist. No matter what the Congress says or what we say as a regulatory agency and maybe even beyond what we want to happen, these disciplines are still going to exist.

Mr. FINO. Mr. Randall, do you think the Congress acted wisely in creating this problem through the passage of the Participation Sales Act?

Mr. RANDALL. Mr. Fino, this is a little far afield for my area and I would prefer not to comment on that.

Mr. FINO. What I want to point out is that we have somewhat created the problems.

Mr. RANDALL. It will add increased complexity to the dimensions of the problem. The complexities were already so immense that I am not sure how much it will add.

Mr. FINO. We are compounding a felony, so to speak.

Mr. RANDALL. You are going to add increased problems.

Mr. FINO. This is what I pointed out on the floor of the House.

Inasmuch as FNMA is going to sell participations in denominations of $10,000 or $5,000, do you see any point in cutting CD denominations off at a higher point?

Mr. RANDALL. On the basis of our evaluation of this situation in trying to segregate—what I try to define as two markets—one, this market of personal savings and the other the large market of idle corporate funds—big corporate funds in the international market, we feel that there would be less impact in the banking situation the higher the cutoff is; $100,000—or even higher. There would be less

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impact in the smaller institutions. You are still going to have problems. If the gap is too large between the rate on small denomination and the rate on large denomination, you are still going to have a flight of funds. But within the disciplines of an economic market, we can distinguish between these two areas, defined for this purpose at least, as personal domestic market and the large denomination in foreign markets. We can do this within limits, but I rather suspect that the limit is stressed if the difference is greater than a half point. We can, within limits, ease this period of transition.

Mr. FINO. I have another question, but I will get to that later because my time has expired.

Mrs. SULLIVAN. Mr. St Germain?

Mr. ST GERMAIN. Mr. Randall, by the same token, this Participation Sales Act as far as interest rates are concerned will be paid on that—it is entirely dependent on the money market at the time they are issued, is that not a fact?

Mr. RANDALL. That is correct.

Mr. ST GERMAIN. So the situation which exists if we can correct it by other means will not be that much affected by the issuance of these sales participations?

Mr. RANDALL. My point only is that we have a major money market that is competing actively for funds and until this problem is solved, we are going to continue in this environment that we have.

Mr. ST GERMAIN. Mr. Kirchner, I take it you are representing Mr. Davis?

Mr. KIRCHNER. I have presented Mr. Davis' statement.

Mr. ST GERMAIN. How do you justify your statement on equal rate competion and yet, by the same token there is no equality as far as the private competition is concerned amongst the financial institutions?

Mr. KIRCHNER. I do not know if I understand the question.

Mr. ST GERMAIN. You went into the Medicare Act and you talk about treating patients and giving medication and let us not take the wrong patient and in so doing hit another patient. I take it you would want to state that whatever steps we take we should insure there is equality as far as rate competition is concerned. By the same token, you know there is not equality as far as the competition is concerned with the type of loans that can be made by the various financial institutions, is that not the case?

Mr. KIRCHNER. I feel that if the market is flexible and the approach is in keeping with monetary conditions, money will flow to those points where it is needed the most.

Now, there is some feeling, I am sure, that commercial banks are not making real estate loans.

Mr. ST GERMAIN. As far as I am concerned, I am convinced, maybe you are not, but I am.

Mr. KIRCHNER. I did not quite hear your entire statement.

Mr. ST GERMAIN. I am convinced of the fact that they are not making real estate loans.

Mr. KIRCHNER. I brought along the figures from my own institution. They show just what has happened during the year.

We find that our total time money has increased, both in savings certificates and savings accounts, about $700,000, but our real estate loans have gone up more than $1 million.

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Mr. ST GERMAIN. Excuse me. As far as the CD's are concerned, in which denominations do you issue?

Mr. KIRCHNER. I commented earlier that we have only eight certificates of deposit that are more than $15,000 and the other are below. I have a complete breakdown of the categories. Our minimum is $100.

Mr. ST GERMAIN. You are aware some of them issue them at $37?

Mr. KIRCHNER. Yes, sir; very much aware of it. I would like to add that we also service a considerable number of real estate loans which we make and dispose of to a secondary market. With us this is about $3 million. If the secondary market could be improved, and I would like to lay this before the committee, so that we could dispose of more mortgages as they are made, since we do not have more funds to hold them, this would be a tremendous way to do more for the real estate and mortgage market.

Mr. ST GERMAIN. The real estate loans you have, are they made within the area that your bank operates in or do you go elsewhere?

Mr. KIRCHNER. The real estate loans we make are generally within 10 miles of our bank. There may be an occasional resident of our community who owns a property 15 or 20 miles away so we would make that loan.

Mr. ST GERMAIN. Unfortunately, some financial institutions are taking money from a community, say on the east coast in Rhode Island and if you look at the portfolio you find 80 percent of that money is on the west coast.

Mr. KIRCHNER. I am very, very much aware that that is going on. This is where the rate differential comes into effect, in attracting money out of the home community and taking it into another. This was a very difficult problem for the small bank within our area, because money was leaving our community and going elsewhere and our local institutions did not have the money. The foreign institution had no willingness to come into our community to make the loans. This is why I feel it is very important that whatever rates are established, they should be such that the local community can hold its deposits to take care of the area's needs.

Mr. ST GERMAIN. I do not know what your experience is at home, but these telegrams—I am going to ask the committee to insert them in the record when I conclude my questioning.

These state very clearly that the savings and loan institutions and the savings banks in Rhode Island are being hurt by those, because they do not have the money to lend out to the homebuilding industry and the homebuilding industry is an important factor in our economy.

Mr. KIRCHNER. I agree with you that there is a real demand for mortgage funds. We, too, would like to make many more home loans than we make because we do not have the additional funds to use in this market. A secondary market would give tremendous opportunity to shift some of these and do a better job for the home industry.

Mr. ST GERMAIN. My time is up. I want to make this statement. That in answer to what you said about small banks, I find that small commercial banks in my area are quietly telling me that they hope we do something about this because they feel that they are forced into issuing CD's in order to compete, but there is nothing they would like more than to be able to get out of this area as soon as possible.

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Mr. KIRCHNER. You are getting right to the heart of what I said about having some sort of a ceiling on all competitive situations. They probably would not have been forced into issuing certificates of deposit if the regulations had been somewhat equal among the institutions.

Mr. ST GERMAIN. I wonder if I could have inserted in the record the telegrams from the mutual savings banks in the State of Rhode Island.

Mrs. SULLIVAN. Without objection, the telegrams will be inserted at this point in the record.

(The telegrams referred to follow:)

PROVIDENCE, R.I., *May 31, 1966.*

Representative FERNAND J. ST GERMAIN,
Longworth House Office Building,
Washington, D.C.:

The seven mutual savings banks of Rhode Island strongly favor and urge you to support limiting the higher interest rate paid on small CD's. Raiding thrift institutions by commercial banks is not sound banking, will result in seriously curtailing further available mortgage money, now very tight in Rhode Island. It would cripple building activity. Cash flow into commercial banks will result in overheating the economy which concerns President Johnson. We advocate a 4½-percent ceiling on CD's of $100,000 as proposed but in no event less than $25,000. Please use your influence to keep the Rhode Island economy sound.

MUTUAL SAVINGS BANKS ASSOCIATION OF RHODE ISLAND,
CHARLES A. POST, *Secretary.*

PROVIDENCE, R.I., *June 1, 1966.*

Congressman FERNAND J. ST GERMAIN,
House of Representatives,
Longworth House Office Building,
Washington, D.C.:

Thanks for phone conversation. No sign of letup in competition for savings dollars which should be going into home construction and purchase of homes. Latest local announcement is 1-year, 5-percent savings with $5,000 minimum. Really appreciate your effort to help the home folks.

Best regards,

RAY BOWEN,
President, Old Colony Cooperative Bank.

Mrs. SULLIVAN. I am going to ask that each member restrict his questioning to 3 minutes so that everyone can have an opportunity to participate, because these witnesses will not be back tomorrow.

Mr. Minish?

Mr. MINISH. Thank you, Madam Chairman.

On these banks—who do you describe as a patient?

Mr. KIRCHNER. I think that this is something that we can carry too far as far as an example. We realize that the savings and loans are pressed for funds and I know that this committee is very much concerned about helping them, so that they can help the housing industry. Therefore I would regard this as the area we are trying to help.

Mr. MINISH. What medication do you describe?

Mr. KIRCHNER. The thing that I feel would help as much as anything is to give flexibility to the Federal authorities. If you are setting ceilings, set them somewhat proportionately. By all means consider a secondary mortgage market, which would give all of us a chance to open up more funds for the building industry.

Mr. MINISH. Mr. Randall, did I understand you correctly, when you said that you are waiting for your survey to come in to find out where this money is flowing to?

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Mr. RANDALL. We have some knowledge, Mr. Minish, on what is happening in the market. It is aggregate, totals rather than specific institutions. We believe we will add to the dimensions with the study.

Mr. MINISH. I might tell you that in the Newark metropolitan area and all over New Jersey, the money from the savings institutions is flowing into CD's. In fact, one bank in Newark had over a million dollars in withdrawals in a very short period of time and was able to trace 50 percent of the withdrawals to one bank in the area dealing in CD's.

Mr. RANDALL. Mr. Minish, we are very aware of the Greater New York market which includes the area you are talking about. This is one that we have been studying in rather minute detail. The study, though, will cover clear across the country. We are afraid that we may be making decisions only on the basis of the New York—the Greater New York market where the high intensity of impact has been. This is where the greatest impact has been in this period that we are involved in, plus some difficulty in southern California. These two areas have been the major problems, but we are concerned about the rest of the country, also.

Mrs. SULLIVAN. Mr. Stanton?

Mr. STANTON. Thank you, Madam Chairman.

Mr. Randall, I was intrigued by your answer to Mrs. Sullivan in referring to the letter of May 31—which I agree does not seem like much time to answer the questions—when you said you could not comment on it because you had to get clearing. Just for my own edification, when you get something like this, what did you mean you have to get clearance? Is that from the Board, the White House, or what?

Mr. RANDALL. First of all, I do work very closely with my associate, who is present with me this morning. But as head of a Federal agency, my statements, as my statement this morning, and speeches are cleared by the Bureau of Budget to make certain that they are consistent with, or at least raise no objection from the point of view of the administration.

Mr. STANTON. Thank you.

I think it is the general consensus of this committee that the primary purpose of these hearings is to learn what is going to happen in the mortgage market for new homes and the housing industry. If there was enough mortgage money, I think the committee would not be having hearings on these bills.

If you have any other thoughts or ideas with regard to this, we would be very happy to hear from you in regard to alleviating this problem. I do not think it is a question of trying to protect the savings and loan industry as such, but the committee is concerned about the availability of mortgage money in the fall. If you have any more thoughts, we would be glad to have them, or if you have any thoughts now we would be happy to hear them.

Mr. RANDALL. Is that to me?

Mr. STANTON. Yes.

Mr. RANDALL. We are concerned with exactly the same problems that you are. We are concerned with the problem of developing a system that allocates markets. And this is primarily the thrust of

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this type of program. Are we going to allocate markets or are we not? Are we going to allocate competition or are we not? And, if we are to allocate or if we are to allocate in periods of stress, I believe that we should have maximum flexibility to allocate so that we do not create problems that we have not been able to foresee at the time any action is taken.

Mr. STANTON. I think I understand.

You feel it is very important from your point of view that this committee would withhold any action until it has an opportunity to receive the report that the Federal Reserve Board is now undertaking.

Mr. RANDALL. I think it is a dimension you should consider as you are looking at your program. I cannot say how much this will add. We hope that it will be significant, and we believe that it is worthy of the time and effort. We recognize decisions still have to be made. We hope that this will be contributory to a broader understanding from our point of view and, helpfully from your point of view.

The CHAIRMAN (presiding). Mr. Weltner.

Mr. WELTNER. Thank you, Mr. Chairman.

Having been limited to 3 minutes only, I have several questions and I hope you gentlemen will limit your answers relative to the amount of time I have.

On page 12, Mr. Randall, of your statement, you say it might be realistic and workable to have a cutoff point of, say, $100,000 and that the limitation should last for 1 year. Do I take it that you would vote "yes" for a bill of 1 year's duration that would prohibit CD's in amounts of less than $100,000?

Mr. RANDALL. It would provide for a differential in rate at $100,000 for 1 year.

Mr. WELTNER. Passbook savings below $100,000 and regulation Q savings above $100,000?

Mr. RANDALL. The proposal as I understand it has been in informal and formal discussions.

Mr. WELTNER. Would you vote for such a program? Would you support such a proposition?

Mr. RANDALL. I would prefer the ability to establish flexibility. But if it has to be rigid, then the 4½ under $100,000 for 1 year conceivably could be passed.

Mr. WELTNER. But the other is inflexibility. You would prefer flexibility on any proposition?

Mr. RANDALL. Rather than have no action, that is preferable. I think some action has to be taken in this market.

Mr. WELTNER. The only action we can take is something inflexible; is that not right? It has to be some dollar amount or some interest amount or some maturity. We cannot pass a bill saying we want to be flexible.

Mr. RANDALL. I think there are ways of doing this and I think there is a point at which the committee could, at least, start.

Mr. WELTNER. Now, Mr. Kirchner, reading Mr. Davis' statement on page 12, with reference to Secretary Fowler's proposal that CD's under $15,000 bear a passbook interest rate and CD's above—Mr. Davis' statement says, "From what we know of rates now being paid in many parts of the country, it would appear that the proposal is workable."

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Do I understand that the ABA supports affirmatively Mr. Fowler's proposition that there be a $15,000 cutoff?

Mr. KIRCHNER. I would not say ABA is pushing for it.

Mr. WELTNER. They would be disposed toward that?

Mr. KIRCHNER. They feel the cutoff is too low and it should be higher.

Mr. WELTNER. That was Mr. Fowler's proposal, $15,000 limit. What cutoff figure does the ABA support?

Mr. KIRCHNER. If it came to where there were no other alternatives, it might work if it was put on a temporary basis, for a short period of time.

Mr. WELTNER. What do you feel is appropriate?

Mr. KIRCHNER. We would like to see elasticity in the picture.

Mr. WELTNER. We cannot say "We are going to have elasticity." Would you say $100,000 would be an appropriate cutoff figure?

Mr. KIRCHNER. I believe his figure was $10,000.

Mr. WELTNER. Would you say $10,000 is appropriate?

Mr. KIRCHNER. Entirely too low.

Mr. WELTNER. $20,000? $30,000?

Mr. KIRCHNER. The higher you go, the better the figure would be for the smaller banking institutions in certain competitive situations.

Mr. WELTNER. But you oppose a $100,000 cutoff figure for a 1 year's limit of duration? Would the ABA oppose that?

Mr. KIRCHNER. I believe not, if nothing else were acceptable.

Mr. WELTNER. What would be acceptable? What would be preferable to $100,000? We have got to find some specific answer.

Mr. KIRCHNER. We would like to see the studies completed, and the Federal authorities set the rates.

Mr. WELTNER. So the ABA does not support any cutoff figure.

Mr. KIRCHNER. That is correct.

Mr. WELTNER. And it opposes any cutoff figure, is that correct?

Mr. KIRCHNER. That is right; we prefer to let the agencies set the figure.

Mr. WELTNER. So the ABA does not support Mr. Fowler's proposals as indicated by section 12 of the proposal?

Mr. KIRCHNER. We are considering various possible cutoffs and will try to have something on that to give to you.

Mr. WELTNER. It would be helpful. I know my time, my 3 minutes, has long since expired. We have had 1 hour and 40 minutes, and frankly, I do not know what either the Federal Deposit Insurance Corporation supports or what the ABA supports. It would be helpful if we may have that information.

The CHAIRMAN. They do not approve and they do not oppose.

Mr. WELTNER. That is my understanding.

The CHAIRMAN. Have you finished?

Mr. WELTNER. Yes.

The CHAIRMAN. Mr. Gettys.

Mr. KIRCHNER. I would like to reiterate that the ABA feels that Secretary Fowler's proposal is workable.

Mr. RANDALL. Mr. Chairman, I would like to answer Mr. Weltner on that. I believe we did, and if I had the chance to submit my full statement, Mr. Weltner, we do support a differentiation in interest rates on CD's, with a higher rate above the $100,000 and a lower rate

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below $100,000, with the ability following that point, and preferably not shorter than 1 year, to adjust to changes in the market that may happen. I do believe that we submitted a positive program.

The CHAIRMAN. Suppose that adjustment was written so that adjustment could be made by the Federal Reserve, with the approval of the President of the United States?

Mr. RANDALL. Mr. Chairman, we suggested to this committee for its consideration a method to be used—either put the power in the Federal Reserve as the central monetary authority, or as recommended in the bill submitted by Secretary Fowler, which is the increase of depositor's and share account insurance to $15,000, which provides for parallel structuring of the changes and ceilings by the Home Loan Bank Board, Comptroller of the Currency, the FDIC, and the Federal Reserve.

The CHAIRMAN. We are under a limitation of time. Mr. Gettys.

Mr. GETTYS. Mr. Chairman, Mr. Randall, and Mr. Kirchner, I am thoroughly confused, which is no unique achievement on your part. It is a constant condition.

In reply to Mr. Weltner, you stated that some action must be taken. I have been sitting here for an hour and I have gathered that neither of you really thinks that the mortgage money market is so tight that action is immediately necessary, essential, or desirable. What is the position of you gentlemen?

Mr. RANDALL. I have not been addressing myself primarily to the mortgage market in my discussion. I believe there are methods of solving problems in the mortgage market that can be positive solutions.

Mr. GETTYS. Could they be by administrative action and not by legislative action?

Mr. RANDALL. Yes, sir.

Mr. GETTYS. Does not some authority reside with the Federal Reserve Board at the present time, and maybe with your organization, and maybe with John Horne's organization?

Mr. RANDALL. Not in the area of flexible ceilings on the subject we are discussing.

Mr. GETTYS. You think legislative action is necessary in order to remedy the situation?

Mr. RANDALL. Yes, sir; I do. The mortgage market can be alleviated. The problems there, by action, can be alleviated by the Home Loan Bank Board and by action by the Federal National Mortgage Association.

Mr. GETTYS. You do not wholeheartedly support Secretary Fowler's logic at this time?

Mr. RANDALL. We have been working with Secretary Fowler and other members of the Treasury and I believe that the proposal that we made today, which is a variation of Secretary Fowler's proposition, is going to be embraced by them. I cannot say this for sure, but I believe we will find this.

Mr. GETTYS. The legislative process is slow.

Mr. RANDALL. Yes.

Mr. GETTYS. Therefore, what is to happen in the interim? Suppose that by legislation this committee can aid in solving the problem. What is going to happen in the interim?

Mr. RANDALL. If there is time of stress of such degree that it is an important consequence to the market, two things that have to be done is the supplying of reserves by the Federal Reserve System and the sup-

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ply of borrowings by the Home Loan Bank Board. These are the two areas and I believe that the administration and the bank supervisory agencies are prepared to do this, if necessary. This is an absolute necessity of our system.

Mr. GETTYS. Should not they take that action now, pending action by the Congress on the proposed legislation, Mr. Kirchner?

Mr. KIRCHNER. I would like to drop back to this Fowler statement, if I might, and say that I believe that I can give you a little more clearly the ABA position on that. We feel that the intent of Secretary Fowler's proposal is good. We would prefer to see the statistics come in that are being gathered by the Federal agencies. We understand they will be available very soon. The exact cutoff point could probably better be established at that time. Likewise, we feel that anything that is set up here should be temporary, such as 1 year or something of that kind.

Mr. GETTYS. My time has expired.

The CHAIRMAN. Mr. Mize?

Mr. MIZE. Mr. Kirchner, I am going to ask you four questions quickly which you should be able to answer quickly, and I am going to ask you one narrative-type question, Mr. Randall and you can use as much time as the chairman says I have left.

What are the maturities of CD's you issue in your bank?

Mr. KIRCHNER. The common issuance is 90 days. Some are issued for a longer period. They are issued as negotiable items, but they are not marketable except, being negotiable, they may be used as collateral. That is the extent of the negotiability.

Mr. MIZE. What is the interest rate you are paying now?

Mr. KIRCHNER. Four and a half percent on certificates. One banking institution pays more. Some savings and loans are paying more—4½ is rather prevalent.

Mr. MIZE. The reserve requirements apply to funds deposited in your bank by passbook savings and CD's. That is the same requirement; is that correct?

Mr. KIRCHNER. That is correct. Our reserve requirement is 5 percent on time money.

Mr. MIZE. Mr. Randall, what would be wrong in eliminating all restrictions on interest rate ceilings for all types of financial institutions and let all financial institutions be obliged to pay whatever market demands; and regulate whatever is felt necessary in the field of financial soundness by way of reserve requirements against loans being left up to the Federal Reserve and you?

Mr. RANDALL. I think, Mr. Mize, the answer to this is one of a problem of timing. We have developed a system that has been dependent upon a regulated ceiling. These ceilings came about in 1934. We have had a period of time where ceilings have been part of the market makeup for financial intermediaries. To move to a free market in a period of stress that we are currently under, would in my opinion bring utter chaos. My plea would be to develop the flexibility so that at a correct period of time when there is less stress in the market we can move toward an orderly free and open market.

The bill that I referred to with the proposal for paralleled structure of control does also provide for a standby posture on controls. I believe that we have need for controls now. I believe that we may have

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need for controls sometime in the future and I believe the question here is one of timing. To eliminate ceilings now, in my opinion, would bring utter chaos in the financial market.

The CHAIRMAN. Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

Mr. Randall, on page 12 of Mr. Kirchner's statement is a statement to the effect—at the end of the first paragraph—that the authority is presently divided between the Federal Reserve and the Federal Deposit Insurance Corporation. He suggests that the authority be removed from the FDIC and granted exclusively to the Fed. I wonder if you can make a comment on that now, or prefer to make one later for the record.

Mr. RANDALL. I would be happy to make one now.

Mr. TODD. Make it brief. I've got one more question.

Mr. RANDALL. At the present time, it is an inappropriate structure of the law. We have the legal responsibility, but we have no basis to participate in the decisionmaking.

The FDIC, if we understand the legislative history, received this power by accident in order to extend rates or interest ceilings control across the market. The genesis is in the Federal Reserve as the monetary authority and we follow, at time reluctantly, as we did in December.

Mr. TODD. You would agree it would be advisable to have it?

Mr. RANDALL. I think the final responsibility and power needs to be placed in either one place or a committee, so there is one final authority.

Mr. TODD. Thank you.

Mr. RANDALL. We have responsibility and no authority.

Mr. TODD. On page 7 of your testimony you state in the last paragraph—

> A differentiation of the ceiling rate on time deposits from that on savings deposits was introduced in November 1964, primarily for balance-of-payments reasons.

It was my understanding that regulation Q did not apply to deposits of foreigners. I wonder if you were personally convinced that this was really the case, that balance-of-payments reasons had anything to do with the regulation Q in 1964?

Mr. RANDALL. Foreign deposits are subject to the interest regulations except that under the Federal Deposit Insurance Act and the Federal Reserve Act, until October 15, 1968, time deposits of foreign governments, monetary and financial authorities of foreign governments when acting as such, or international financial institutions of which the United States is a member are not subject to the maximum rates of interest on time deposits.

The CHAIRMAN. Mr. Ottinger.

Mr. OTTINGER. Mr. Chairman, I would like to reassure Mr. Kirchner with respect to one thing and that is I did not have any idea at the time I introduced my bill that small banks in the Midwest had large volumes of certificates of deposit. I think we will try to correct the legislation to take account of your problems in that respect. We still do not have the information on CD's that we would like to have and should have in framing sound legislation.

I do think we have a real problem that we are facing and the fact that you do not have a crisis now is really quite deceiving because

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the failure of the savings and loan industry to make commitments will not make itself felt until the building which is taking place on current commitments has been completed.

Mr. Randall, you made a great plea for flexibility and I started out with a very favorable disposition toward providing that flexibility; but we asked the Federal Reserve Board, when its members were here to testify, if we gave them the authority to discriminate between various denominations of certificates, would they use it? And they gave us a categorical "No." With that kind of attitude expressed by the Federal Reserve Board, what would be the sense of providing the flexibility you asked for?

Mr. RANDALL. All I can refer to in this regard is the fact that very few foresaw the impact that regulation Q's full point increase in December would have in this market. It has had an adverse influence. It has moved faster than anyone anticipated and, to give a categorical no, is perhaps an answer with lack of depth. I think it is going to require a flexible answer and I believe that if we build rigidity into any market at this point we are going to regret it, because new problems are bound to follow from any given rigidity. We are going to need other tools in the period of stress that we are in—I use "stress" rather than a stronger term. If we do not have the tools to deal with the period of stress now, and stresses that will come in the future, I think we are indeed shortsighted in our views of the needs of this economy.

Mr. OTTINGER. Maybe we should give you the authority instead of the Federal Reserve Board.

With respect to the survey, we have indications that the survey that is being taken will not give us adequate information. Namely, we were told that even the survey will not supply us with the amount of money in certificates of deposit by denomination below $10,000, $15,000, $25,000, and $100,000. Do you have any information on that?

Mr. RANDALL. We did a similar study and we did it prior to these hearings, and I am sure that there are gaps, but I do believe it may add dimension to your knowledge. That really is as far as I can go. I think we are certainly going to know more about the market than we know now.

Mr. OTTINGER. My time has expired.

The CHAIRMAN. It occurs to me that the facts brought out in these surveys by the FDIC and the Federal Reserve will be about 2 months old when they are ready to release them. Is that correct?

Mr. RANDALL. Mr. Chairman, it takes about that long; yes, sir. There is just no way of beating that.

The CHAIRMAN. They will be quite useless, of course.

Mr. RANDALL. You were out when we discussed this. I just did make the comment that this was in process and there is an awareness of it. We have to go on what knowledge we have now.

The CHAIRMAN. Mr. Widnall?

Mr. WIDNALL. Thank you, Mr. Chairman.

I believe you made some comment about the secondary market. I do not know whether or not you are familiar with the bill I have offered to increase the authorization for FNMA by $110 million.

Mr. RANDALL. Yes, I am.

Mr. WIDNALL. Do you believe this will be helpful at this time?

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Mr. RANDALL. I believe that in this period of time there is going to be need for direct action rather than indirect action or at least added to indirect action and, probably, this market is going to be supplemented—needs to be supplemented—either by direct loans by the Home Loan Bank Board or by increased FNMA activity. Both can contribute to helping to solve this period of adjustment that we are in.

Mr. WIDNALL. Do you think it would be proper?

Mr. RANDALL. I believe it could add a solution to this problem.

Mr. WIDNALL. Mr. Kirchner, could you answer that, please?

Mr. KIRCHNER. Yes; I have spoken several times here in favor of increasing money for the secondary market and I think any step in that direction is good. I would feel that it should be broader, or as broad as possible, so that it could take into account conventional mortgages, perhaps, as well as all types of mortgages in order to give the greatest relief possible. I am not familiar with your precise bill and its details, so I cannot speak specifically about the bill.

Mr. WIDNALL. Thank you. I believe the amount of CD's in 1960 was $4.6 billion and is now running about $18 billion—$17.6 is the last figure I believe I saw.

The CHAIRMAN. Mr. Widnall, would you yield for just a minute? I think you are comparing nonnegotiable CD's with negotiable CD's. I am afraid that the record would not be clear on that. The $4.5 billion you talked about includes mostly the nonnegotiables. The $17.5 billion that you talked about are negotiable? Is that correct, Mr. Randall?

Mr. RANDALL. I believe so, Mr. Chairman. We could supplement that but I think my memory is right.

Mr. OTTINGER. Would you provide that figure?

Mr. WIDNALL. Would you supply the figure for the record?

Mr. RANDALL. Well, if we can at this point.

(The information requested follows:)

Some 250 banks hold about $17.6 billion of negotiable CD's in denominations of $100.000 or over. Another 1,500 member banks, according to the Federal Reserve survey of time and savings deposits conducted in late December 1965, also issue negotiable CD's in varying denominations, while close to 3,000 banks offer various types of smaller denomination CD's which are largely nonnegotiable.

According to an FDIC survey of April 1965, there are over $36 billion in CD's of all types outstanding, compared to the $4.5 billion cited by Mr. Widnall. Many of these CD's are technically negotiable—but are essentially nonmarketable or are marketable only at rates higher than those quoted for so-called prime CD's issued by a few of the very largest banks.

Mr. KIRCHNER. I wonder if I might just say that in the matter of defining negotiable and nonnegotiable, in our area it is very difficult to determine which is which, even within the bank when you look at the document. So many of our small banks have used the standard form. When changes occur, they merely add a couple of words to say that it will be automatically renewed, or something of that kind. I have had an attorney review one or two and he said, "I think they are nonnegotiable but I am not sure." The balance sheets just carry them as certificates of deposit.

We have wondered if it would help to think in terms of marketable certificates and, perhaps, nonmarketable in the sense that those we have in the small communities really have no quick market.

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Mr. RANDALL. If I may address my self to that, also, my general counsel in the legal department informed me that this category of "nonnegotiable CD's" which, primarily, is the smaller CD in the agrarian Midwest and the smaller banks of the country may be negotiable instruments and may be close to or very similar to the negotiable CD in the larger market and we have a very difficult time defining the two types legally.

Even many instruments that say not negotiable on their face may indeed be negotiable instruments in meeting the law. So these are very difficult things to define. It is in a fuzzy area of definition.

Mr. WIDNALL. Mr. Randall, several U.S. Government securities now yield 5 percent or more. If we impose a limit under that of the Government bond yield, would not funds then seek the higher yields of Government bonds?

Mr. RANDALL. We discussed this at length, Mr. Widnall, while you were away, and that is, no matter what rule or regulation or statute may be intervened, we cannot avoid too far the disciplines of a free and open market.

Mr. WIDNALL. In 1959 we had a Government note issued at 5 percent. In February of this year, we again had a 5-percent note referred to as the Johnson 5–1970. In 1958, holdings of Government securities by partnerships, individuals, and so forth, were $63.7 billion. By the yearend 1959 this total had risen to $69.4 billion, an increase of $5.7 billion. By the year ending 1960, when interest rates had moderated, the total had dropped to $66.1 billion, followed by a total of $65.9 billion in 1961 and $66 billion in 1962.

What I am saying is that control of interest rates in financial institutions is by no means the whole story. Do you gentlemen agree with that?

Mr. RANDALL. Yes, sir.

Mr. KIRCHNER. Yes, sir.

Mr. RANDALL. It can be partially the story in a period of adjustment, but I agree, it cannot be the whole story. We know that savings habits appear to be changing. In Economic Indicators, which is put out by the chairman's Joint Economic Committee, we do see that personal savings as a percentage of personal income is declining and this indicates a change in savings habits that may also be a dimension in this pattern.

Mr. WIDNALL. My time is up.

The CHAIRMAN. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Last year, when we had hearings on legislation concerned with the possible consolidation of the Federal banking regulatory agencies, I remember a literal parade of witnesses coming before the committee praising the dual system of banking in this country, chiefly because of its flexibility, its resourcefulness and strength. I wonder, from the mail that I have received, I think the problem we are dealing with is a national problem. We receive letters from savings and loan associations, from a number of States in the Union.

Can either of the witnesses tell me one single step taken by any State in connection, in trying to alleviate this problem of CD's?

Mr. RANDALL. You have a number of States that have their own interest regulations. Arkansas has a ceiling of 4½. Indiana, I be-

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lieve, has either 4 or 4½ ceiling. There are several that have adjusted in this intervening period short of the action taken by the Fed in December of 1965. And there are States where we have—where we see intervening steps, Mr. McGrath. I can get you a list of those that have separate interest controls and their action. We would be happy to submit it for the record at this time.

Mr. McGrath. I would like to see that. Apparently, this problem that we are having hearings about does not exist in Arkansas and Indiana.

Mr. Randall. I attended a series of meetings in Arkansas a few weeks ago. The only reaction I got from the Arkansas Bankers Association was that they certainly did not want to see small denomination CD's of any form outlawed. This would be chaotic in their operation. They have a maximum ceiling of 4½.

Mr. McGrath. I would like to see it. Maybe we can learn something from what the States have done in this area.

Mr. Randall. We would be happy to supplement the record, Mr. McGrath.

(The information requested follows:)

The latest compilation available to us indicates that sixteen States have statutes or regulations which prescribe maximum rates of interest which banks may pay on time deposits. These ceilings range from 2½% per annum to 5½% per annum. The following table lists the States in which such statutes or regulations are in effect:

Maximum interest rates payable on time and savings deposits in commercial banks prescribed by State laws or State banking authorities

State	Maximum interest (percent per year)		Set by—		Remarks
	Time deposits	Savings deposits	Statute	Regulation	
Arkansas	4	4	X		Arkansas Revised Statutes, § 67–517.
Colorado	5½	4	X	X	§ 14–3–2 of Colorado Revised Statutes of 1963 sets limit at 3 percent for State banks, but State banking board may permit a higher rate, to allow competition with national banks, limited to the amount paid by national banks. Listed rate set Dec. 16, 1965.
Indiana	4½	3½		X	Rate on time deposits is limited to 4 percent on deposits of 89 days or less. Listed rate effective Dec. 29, 1964.
Iowa	4	4	X		Deposits bearing higher rates must be classified as borrowed funds, and as such, must be reported to the superintendent of banking. (Iowa Code Annot., § 528.11).
Louisiana	(*)	(*)	X		Funds on which a bank pays 5 percent or more must be classified as borrowed money, except public funds. (Louisiana Rev. Stat., § 6:11). * Less than 5 percent.
Massachusetts	* 5	5	X		The Annotated Laws of Massachusetts, § 172.61 (Trust Companies). * Banking companies: 5 percent except with approval of Commissioner (ch. 172A, § 5) Banking Companies.
Michigan	2½	2½		X	Applies only to banks not subject to Federal regulation of interest (Michigan Stats. Ann., § 23.822).
Minnesota	5½	4	X	X	§ 48.25 of the Minnesota Statute Annotated limits interests on deposits to that which may be paid by member banks of the Federal Reserve System, but provides that the rate is to be set by the commissioner of banks within the limitation. Listed rate set Jan. 27, 1965.

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Maximum interest rates payable on time and savings deposits in commercial banks prescribed by State laws or State banking authorities—Continued

State	Maximum interest (percent per year)		Set by—		Remarks
	Time deposits	Savings deposits	Statute	Regulation	
Mississippi	4	3½		X	§ 5208 of Mississippi Code of 1942 authorizes the State control to fix the interest rate on deposits, up to rate paid by national banks. The 4 percent rate applies to funds on deposit at least 1 year and 90 days CD's of not less than $500,000. 3½, 2½., and 1 percent are allowed on deposits of at least 6 months, 90 days, and 30 days, respectively. Listed rate effective Feb. 6, 1964.
Nebraska	5½	4		X	Listed rate effective Dec. 7, 1965 (Rev. Stat. Nebr., § 8-133).
Nevada	4			X	Superintendent may fix a rate similar to that fixed by the FRB (Rev. Stat. Nev., § 663.030).
New Hampshire		3½	X		Limited to 3½ percent on savings accounts, unless assets of savings departments exceed deposits by 5 percent (New Hampshire Rev. Stat. Annot., § 386:10).
New York	5½	4		X	(Regulation, pursuant to McKinney's Banking Law, § 14(h) (1), (2).) Listed rate effective Dec. 7, 1965.
North Dakota	4½	4	X	X	Interest limited to 4 percent unless the State banking board authorizes a greater rate, however not to exceed 6 percent (North Dakota Century Code, § 6-03-63). Listed rate effective Jan. 1, 1966.
South Dakota	4	3½		X	(Regulation, pursuant to S.D. Code of 1939, § 6.0417.) Listed interest effective Jan. 18, 1966.
Tennessee	4	4	X		Tennessee Code Annotated, § 45-401.
Utah	(*)			X	*4¼ percent maximum for inactive public funds, established July 5, 1965.

NOTES.—1. States not listed have no statutory or regulatory proscription on interest rates of commercial banks. 2. Where no interest rate indicated no rate has been prescribed.

Mr. KIRCHNER. May I add that in the State of Minnesota we have had a fixed 3½ rate. That was changed in the last session of the legislature to give the banking department the right to establish the rate. It took them 30 days to change the rate in Minnesota. During that time we lost almost a million dollars in deposits out of our open savings accounts because we could not pay 4½ percent to meet the demand.

At the end of about 30 days they established 4½ percent for certificates which we put into effect. I have figures showing that on December 31 we had total time deposits of $12,063,000. As of May 25, we had $12,110,000. Very little difference. But during that time the regular savings accounts had dropped practically $600,000 and the certificates of deposit increased $600,000, which has happened in numerous banks. That is, there were merely shifts of regular savings accounts into the time certificates and it was our only way of holding that money.

We are loaned approximately 63 percent. And in addition to that, we are required to have reserves of 12 percent on demand and 5 percent on time deposits. And in addition to that, we have considerable funds for which we must pledge collateral and by the time we take care of all these required funds, there is very, very little left for us in the way of additional loaning possibilities. What there is, is more or less involved in municipal securities, which at this time are not really

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easy to move or change. If we were to lose these certficates of deposit we would have to further curtail lending to our people. Many loans that would have been made a year or two ago we are unable to make now because we lack available funds.

This is true for many banks and if they lose their certificates of deposit they are going to have to cut back even further. That is why I so strongly advocate some strengthening of the secondary mortgage market to enable us to make these home loans and to sell them, and still to take care of our requirements.

Of course, we all know if you try to put the brakes on, it is going to pinch. It is pinching on loans to our small businessmen just as it is pinching over in the home area, too.

The CHAIRMAN. We will not have any votes tomorrow. We want to have an executive meeting. Mr. Widnall and I discussed this matter a few days ago. We are both concerned, and all the members of the committee are greatly concerned about this chaotic situation that is existing in the building industry, in particular, and about the tremendous disastrous effects from raising these rates to 5½ percent. We are all greatly concerned about that and we want to do something as quickly as possible that will relieve the situation.

In accordance with our meeting which Mr. Widnall and I agreed we should have, and we had the members here, we wrote the agencies as reported in the press yesterday and asked their views on certain things and we expect their answers by this evening or before 10 o'clock tomorrow morning, as stated in the letter. I will read the letter since part of it has been carried in the press. I addressed the letter to you, Mr. Randall, and sent a similar letter to the other agencies.

DEAR MR. CHAIRMAN: As you know, the Committee on Banking and Currency has been holding public hearings on H.R. 14026, a bill to prohibit the issuance of negotiable certificates of deposit by commercial banks.

Several other proposals aimed at ending the current rate war among banks and between banks and thrift institutions have also been advanced, each approaching this very serious problem in somewhat different ways.

In order to expedite matters so that a sound and appropriate solution may be speedily arrived at, your comments on the following legislative approach will be appreciated:

(1) Provide that the statutory range of required reserves for time deposits be changed from the present 3–6 percent to: (a) 8 percent minimum and a maximum equal to the existing reserve on demand deposits for reserve city banks, without altering the reserve with respect to passbook savings deposits. The Federal Reserve Board would be required to establish reserve of at least 8 percent according to class and size of time deposit by no later than January 1, 1967; (b) 4–10 percent;

(2) Provide that no time deposit may have a minimum maturity of less than (a) 1 year, (b) 6 months;

(3) Provide that the maximum rate of interest payable on time deposits be 4½ percent per annum for deposits less than $100,000. The present ceiling of 5½ percent would apply only to time deposits of $100,000 and over.

In anticipation of the committee meeting at 10 a.m., Friday, June 3, we would appreciate your attention to this question by that time.

The same letter was sent to:

Gardner Ackley, Council of Economic Advisers;
K. A. Randall, Federal Deposit Insurance Corporation;
Henry Fowler, Secretary of the Treasury;
J. J. Saxon, Comptroller of the Currency;
John Horne, Federal Home Loan Bank Board;
All members of Federal Reserve Board;

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Harry P. Greep, National League of Insured Savings Associations;

Archie K. Davis, American Bankers Association; and

Norman Strunk, U.S. Savings and Loan League.

I assume that the American Bankers Association response will be in by tomorrow morning at 10 o'clock, is that correct?

Mr. GOLEMBE. We will have our response in; yes, sir.

(The replies to the above letter follow:)

CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS,
Washington, June 2, 1966.

Hon. WRIGHT PATMAN,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The Council of Economic Advisers has examined the various proposals for changes in legislation relating to commercial bank time and savings deposits outlined in your letter of May 31. Our views on these proposals are summarized as follows:

(1) We believe that there is good reason to prefer a smaller differential than now exists between reserve requirements against time deposits and those against demand deposits. In general, we would prefer reserve requirements graduated by size of bank. But because of technical problems in establishing such a new reserve system, an interim measure would be desirable. A range of 4 to 10% for time deposits (with no change from the present regulation in regard to passbook savings) would seem to be a satisfactory alternative to the present system.

(2) We do *not* believe that minimum maturities for time deposits of either one year or six months should be imposed.

(3) We recommend that the Board of Governors be empowered to set separate ceilings for time deposits over and under $100,000. We believe that the present 5½% ceiling should apply only to time deposits of $100,000. However, the figure of 4½% for deposits under $100,000 seems too low. We would recommend a figure of 5%.

Our position on these proposals follows from our analysis of developments in financial markets over the past few months.

The Current Situation

Since December when Regulation Q was changed, rates offered by commercial banks for negotiable CD's have risen sharply. Banks are generally paying 5½% for maturities over 6 months and over 5¼% for short maturities. At the same time there has been a widespread increase in the rates offered on smaller certificates of deposits. These rate developments reflect the rapid growth in demand for funds in all sectors of the financial market and the large advance of economic activity during the first quarter of the year, as well as the actions of the Federal Reserve System.

Rates on securities have risen sharply since December and banks have been faced with severe competition for funds as against all types of marketable securities. At the same time, business loan demand has been very strong. In spite of the rise in rates offered, the growth of time deposits at commercial banks has been smaller this year than during the corresponding period last year.

The flow of funds to mutual savings banks and savings and loan associations has been sharply reduced by competition with marketable securities as well as with commercial banks. The thrift institutions are not in direct competition against negotiable CD's, but large banks have been able to draw negotiable CD business away from medium-sized banks. Those banks in turn have competed more aggressively for personal funds. Thus the negotiable CD market does have an impact on the thrift institutions, although it is only one of many factors affecting their position.

The ability of banks to compete for funds by the use of certificates of deposits has intensified rate competition. Given over-all monetary policy, banks have probably been able to provide a greater volume of loans to their customers than would have been possible without CD's. At the same time, it is possible that some interest rates are higher than they otherwise would be. However, competition for CD's is only a marginal factor in pushing up interest rates.

The basic factor behind the rise in interest rates is the very strong demand for funds which accompanies rapid economic expansion. This demand has outpaced the supply of credit even though the Federal Reserve permitted the money

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supply to expand at an annual rate of 6.6% during the first four months of the year.

The economy is expected to continue to expand rather strongly for some time to come, and we must therefore anticipate a continuing strong demand for credit. Commercial banks and thrift institutions will have to continue to compete actively with one another and with the securities market for a limited supply of funds. In the long run, competition between different institutions and different users of credit is desirable for economic efficiency. But an all-out competition for funds at this time may be a destructive form of competition. It may drive rates to excessive levels in relation to the rates which can be sustained in the longer run. It could seriously damage the position of those institutions which happen to be in the weakest competitive position at this moment.

Some constraint on competition for time deposits therefore appears desirable at this time. A modification of the third proposal in your letter appears to provide the best means for this purpose. We do not believe that it is feasible to reduce the ceiling rates on the large certificates of deposits which compete with other money market instruments.

However, it is possible and important to take action to prevent excessive competition between banks and other institution for personal deposits. That can be achieved by drawing a distinction between deposits over $100,000 and those under that figure.

We recommend that the Board of Governors be empowered to set separate ceilings for time deposits over and under $100,000. We believe that the present 5½% ceiling should apply only to time deposits of $100,000. However, the figure of 4½% for deposits under $100,000 seems too low. We would recommend a figure of 5%.

We believe that a ceiling of 4½% would be too low. There are very substantial amounts of time deposits (in the under $100,000 category) now receiving interest rates above 4½%. The rate-sensitive portion of these funds could be expected to move into securities if the time deposit rate were reduced to 4½%. The loss of substantial funds by a limited group of banks could cause serious problems for those banks and their communities.

The imposition of a 5% ceiling on deposits under $100,000 could cause difficulty to a few institutions (which could, of course, obtain assistance from the Federal Reserve if necessary); but these difficulties would be of much smaller magnitude than in the case of a 4½% ceiling.

Reserve requirements

We believe that a change in reserve requirements for time deposits could be useful. A reduction in the differential between reserve requirements for time and demand deposits would reduce the impact of shifts between time and demand deposits and thereby make the conduct of monetary policy somewhat easier. To have the desired effect, the required ratios should be higher for those time deposits which are most volatile and rate sensitive. The proposal to increase reserve requirements for time deposits on open account and for certificates of deposits, while leaving requirements against passbook accounts unchanged, goes in the right direction. For the present—as between your proposals 1(a) and 1(b)—we would favor the second: a range of 4 to 10% against time deposits (excluding passbook savings). We do not believe that it would be desirable to introduce a mandatory increase in reserve requirements, since the changes in reserve requirements could interfere with the appropriate conduct of monetary policy.

Over the longer run, we tend to believe that a system of reserve requirements graduated by amount of time deposits held would be desirable. Such a system would impose higher reserve requirements on large banks, where deposits are, in general, the most volatile and rate-sensitive. However, there are many technical problems involved in establishing a system of graduated reserve requirements. It therefore would seem useful to permit the Board of Governors to raise time deposits reserve requirements, with the understanding that the Committee would also, in the future, consider the possibility of graduated reserve.

It should be noted that although an increase in reserve requirements is desirable because it reduces the impact of shifts between deposits, higher reserve requirements would have only a marginal effect on rate competition.

Minimum maturities

We do not believe that it would be desirable to provide that no time deposit may mature in less than six months—still less that a one-year limit be imposed. A large volume of time deposits and certificates with maturities of less than

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six months is now outstanding. Such deposits are a major form of intermediate liquidity to many corporations and individuals.

The elimination of relatively short maturity time deposits would cause great inconvenience to the public. It would necessitate the development of new forms of liquidity instruments.

To comply with the proposed legislation, banks might have to liquidate an enormous volume of assets, or else the Federal Reserve might have to provide reserve assistance on a large scale. The consequences of such a drastic shakeup in financial markets are difficult to predict, but we do not doubt that they would be thoroughly undesirable.

I hope that these comments will be helpful.

Sincerely,

GARDNER ACKLEY.

FEDERAL DEPOSIT INSURANCE CORPORATION,
Washington, June 2, 1966.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In your letter of May 31, 1966 you have asked for our comments on the following legislative proposals:

(1) Provide that the statutory range of required reserves for time deposits be changed from the present 3–6% to: (a) 8% minimum and a maximum equal to the existing reserve on demand deposits for reserve city banks, without altering the reserve with respect to passbook savings deposits. The Federal Reserve Board would be required to establish a reserve of at least 8% according to class and size of time deposit by no later than January 1, 1967; (b) 4–10%;

(2) Provide that no time deposit may have a minimum maturity of less than (a) one year, (b) six months;

(3) Provide that the maximum rate of interest payable on time deposits be 4½% per annum for deposits less than $100,000. The present ceiling of 5½% would apply only to time deposits of $100,000 and over.

In our opinion the proposal set forth in 1(a) above is excessive. With reference to the proposal in 1(b) above, we would suggest that the statutory range of required reserves for time and savings deposits be changed from the present 3–6% to 3–10%, with the Board of Governors of the Federal Reserve System being authorized to prescribe different rates for different classes of deposits, for deposits with different maturities, and for deposits of different amounts.

With reference to proposal 2 above, we can see no benefit from the imposition of a fixed minimum maturity on time deposits. The problem being dealt with does not arise from maturities but from competitive rate differentials. This proposal would impose rigidity where we believe flexibility is needed. However, 2(b) is preferable to 2(a).

With reference to proposal 3, we agree with permitting a differential in rate at the $100,000 cutoff, but would object to the rigidity of the proposed rates below and above this cutoff amount. We believe the Board of Governors should have flexibility to determine these rates and amounts as necessary.

These matters, other than the reserve requirements, are more fully discussed in my testimony presented to your Committee on June 2. As we indicated therein, the proposed restrictions, if adopted for banks, should be adopted for their nonbanking competitors.

We have been advised by the Bureau of the Budget that there is no objection from the standpoint of the Administration's program to the submission of this letter.

Sincerely yours,

K. A. RANDALL, *Chairman.*

THE SECRETARY OF THE TREASURY,
Washington, June 2, 1966.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Your letter of May 31 asks for my comments on certain proposals addressed to calming the current rate competition among various

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financial institutions. Some of these matters were already discussed when I appeared before your Committee on May 19, but I am glad to supply additional comments on the specific approaches outlined in your letter.

If I may, I should like to start with the third point mentioned in your letter since it seems to me that the greatest promise for speedy and effective action to reduce the current degree of rate competition lies in placing a temporary rate ceiling on time deposits in the smaller denominations. My suggested approach on May 19, as you may recall, was to provide discretionary authority for setting a lower ceiling on time deposits up to the amount covered by FDIC insurance (now $10,000); I suggested a ceiling rate of 5% on these smaller deposits, compared with the current prevailing maximum rate of 5½% on time deposits. As my statement also indicated, there may well be merit in drawing the line between large and small deposits at a higher figure—perhaps in a range of $25,000 to $100,000.

There are some disadvantages and, perhaps, some dangers in setting a 4½% rate ceiling, as suggested in your letter. A 5% ceiling on smaller time deposits would be distinctly preferable. This is partly a matter of equity—avoiding a remedy that penalizes the small saver unduly. It is also a matter of seeking to avoid solutions that could be disruptive to financial markets and financial institutions; for with many market instruments carrying rates above 5%, there could be undesirably large outflows of funds from institutions that paid only 4½% on sizable amounts of deposits. Possible ill-effects on our international balance of payments would be another drawback to the 4½% rate. Moreover, I would be quite reluctant to propose a rate level that would oblige banks to pay a lower rate on time deposits than is paid by other thrift institutions in some sections of the country; and yet if the Congress were also to set a maximum rate of 4½% for savings and loan associations some of those institutions might encounter very serious drains indeed.

In short, a temporary maximum rate of 5% on time deposits up to $100,000 would have as its main thrust the prevention of further escalation of the rate competition. This would allow additional time for financial institutions to adjust to the changing competitive relationships in financial markets without undue disruptions of useful flows of financing.

The first point in your letter, relating to reserve requirements, touches on a matter that I also mentioned in my May 19 statement to your Committee. I said then that it might be desirable to provide the monetary authorities with discretion to set higher reserve requirements on large "money market type" CD's than on other time and savings deposits. Such powers should put the monetary authorities in a better position to exercise a constructive influence over the role played by CD's in our financial structure.

It should be emphasized, however, that action with respect to reserve requirements on CD's could not be expected to serve as an effective means of curbing the current degree of interest rate competition for time deposits. In my view, this is not an effective alternative to the 5% rate ceiling on smaller time deposits that I mentioned above.

The second point in your letter deals with proposals for a minimum maturity on time deposits. As you know, the Federal Reserve already has authority to set different ceiling rates on different maturities of time deposits, so that they could now accomplish the effective elimination of shorter maturities. I believe, however, that there could be some serious disadvantage in legislating the banks out of competing for short-term money, potentially giving rise to sizable outflows of funds from banks into money market securities on which maturities could be set more flexibly. In other words, I would see little to gain, with respect to resolving the problem of rate competition, and possibly much to lose in terms of smooth market functioning, if the minimum maturity on time CD's were to be increased significantly.

One final thought—I believe that whatever may be proposed in the way of a revised interest rate ceiling on CD's, care should be taken not to disturb the exemption of foreign central banks from Regulation Q ceilings. The removal of this exemption could have an appreciable adverse effect on our balance of payments.

Sincerely yours.

HENRY H. FOWLER.

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COMPTROLLER OF THE CURRENCY,
Washington, June 2, 1966.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. PATMAN: We appreciate the opportunity to comment on these proposals. As you know, I have opposed all legislation in this area on the grounds that there is no danger or problem of sufficient magnitude to justify the additional restrictions which these measures would impose. It simply does not seem wise to continue to protect the savings and loan industry from the competitive pressures of other financial institutions. In addition, if the Congress' judgment is that we should subsidize the housing market, I believe there are ways which are more direct and efficient and which would provide more assurances that funds would flow into those specific kinds of housing which we wish to expand. Since it is not clear that these proposals will accomplish anything worthwhile, and since it is abundantly clear that they will further impair the efficiency of our financial system, I remain opposed to this kind of market interference.

The first proposal specified in your letter—to raise the reserve requirements on time deposits—would not accomplish anything other than making time deposits less profitable to commercial banks. Banks would still accept time deposits and interest rates would still be determined by the market. Banks, just like savings and loan associations, would still have to compete for funds with other financial institutions as well as with various money market instruments. Savings and loan associations already possess artificial advantages, such as tax benefits, in this competition. It would not seem to be in the public interest to saddle commercial banks with additional disadvantages, which they will have to live with forever after, in order to solve a temporary problem of the savings and loan industry.

In addition, the level of reserve requirements does not, of course, have anything to do with bank solvency. The sole function of reserves is to facilitate monetary policy, and the "correct" level of reserves is a function of economic conditions and monetary policy objectives. Thus, this proposal would have the further drawback of confusing monetary policy tools and objectives with the competitive relationships among financial institutions. This kind of confusion is exactly the problem the Federal Reserve encountered in December when it raised the Regulation Q ceiling. By raising reserve requirements on time deposits we will create even more confusion and uncertainty than exists now. Increased reserves on time deposits will also immobilize a larger part of bank assets and therefore restrict their lending capability, which will reduce the volume of loans and tend to increase interest rates.

Not many years ago, in fact, the Commission on Money and Credit recommended just the opposite of this proposal.

"The Commission believes it is unnecessary to require statutory reserves against savings and time deposits in banks and competing institutions. * * * The Commission recommends that existing statutory reserve requirements on time and savings deposits be repealed, * * *."

I believe that the Commission was correct and, therefore, am against raising reserve requirements on time and savings deposits.

The second proposal you advance is not entirely clear to me. If it would simply impose a minimum maturity on time deposits and would not interfere with the negotiability of these deposits, it would have some impact on the CD market, but would probably not wipe out this market.

On the other hand, if the second proposal is intended to make all time deposits non-negotiable for at least six months, it would virtually abolish the negotiable CD. No investor will wish to buy a CD which he cannot liquidate for six months. As money market instruments go, six months without liquidity is a very unattractive investment. This proposal, therefore, will eliminate an attractive money market instrument for investors and, as a result, make it increasingly difficult for banks to meet their liquidity needs. Banks will lose the flexibility which they need to meet vicissitudes in market conditions.

The third proposal—to provide a maximum rate of 4½ percent on time deposits of less than $100,000—is just another variation of Regulation Q, except that it would aggravate the existing discrimination against small savers. As you know, I have on many occasions expressed my opposition to using Regulation Q to regulate competition among financial institutions. This proposal is even worse in that it allows discrimination on the basis of the depositor's wealth in regulating prices banks can pay.

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One important aspect of all these proposals must be noted. If these proposals are successful in relieving savings and loan associations from competitive pressure, they can do so only by encouraging the outflow of funds from commercial banks, particularly funds invested in CD's. While I am confident that the liquidity position of national banks is very sound, allowing the banks to face even abnormal attrition of deposits, some of the proposals that have been advanced would have very drastic effects on bank liquidity and money market conditions. If, for example, negotiable CD's were outlawed and a six month minimum maturity for time deposits imposed, literally billions of dollars of CD's could not be renewed and this outflow would greatly reduce bank reserves. Not only would the effect on many banks be drastic but conditions in the money and credit markets would become extremely tight and chaotic. The financial structure of this country is strong and resilient. It can withstand even sizable shocks, but there is, of course, some limit beyond which we cannot safely go. The effects of some of these proposals could be very serious. I strongly urge that the Committee consider these possible effects carefully before taking action. This is an area in which hasty, ill-considered action can have drastic repercussions—the side-effects of the medicine may be much worse than the disease.

In regard to housing, if the Congress decides that the traditional processes of a competitive market place should *not* decide what amounts of funds should be allocated to each sector of the economy, but decides that housing should receive special consideration, I would favor a plan which would encourage all financial institutions equally to allocate more funds into housing. For example, we could allow commercial banks to have a "tax-free loan loss reserve" on real estate loans similar to that now enjoyed by savings and loan associations. If commercial banks, instead of a 2½ percent "reserve" account, could keep a "reserve" account of twelve percent of real estate loans, as do savings and loan associations, banks would be encouraged to put a larger volume of their funds into the housing market. This kind of solution would at least avoid the pitfall of "overbuilding" which could result from an indiscriminate flow of funds into savings and loan associations.

In summary, I am opposed to all three proposals on the grounds that they represent unnecessary interferences with competitive market processes, thereby reducing the efficiency of our financial system and hindering the efficient allocation of our resources.

Sincerely,

JAMES J. SAXON.

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., June 3, 1966.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of May 31 requesting comments on various legislative proposals concerning time deposits. Our comments follow the same order as the proposals in your letter.

(1) Insofar as point number (1) is concerned, if legislation of this type is adopted we prefer proposal (a). When I was before the Committee, I indicated in response to a question that we thought this plan had some merit, and we are still of that opinion. It seems only fair to point out, though, that there is some reason to doubt that banks would be significantly deterred by increased reserve requirements alone.

(2) We think point number (2) would be more effective than number (1). We have no strong preference between (a) and (b). However, for your information, prior to April 1966 the Federal Home Loan Bank Board did not permit certificates of less than one year to be issued by a Federal savings and loan association at a differential in rate from that for regular passbook accounts. Beginning in April we did permit a six-month certificate of not less than $2,500 because of the competitive situation created by commercial banks.

(3) With respect to point number (3), we should like to endorse the proposal as stated. It appears to be the one that would be most effective, although limiting maturities would also be of value. In enacting legislation along the lines of number (3), it would be essential to include provisions closing any possible loophole under which intermediaries such as account brokers could aggregate holdings of separate investors investing individual amounts of less than

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the prescribed minimum into consolidated deposits equaling or exceeding such minimum.

It should be pointed out that this Board has no authority to impose rate ceilings, except for Federal associations and to some extent by restricting advances for expansion. The latter device is of minor consequence today. It may be necessary, therefore, to provide this agency with appropriate authority covering all member associations if Congress desires the Federal Home Loan Bank Board to pursue a course related to that of the banking agencies. In this regard, I would call your attention to H.R. 7404 of the 88th Congress and its 1965 counterpart which was transmitted to the President of the Senate and the Speaker of the House of Representatives by the Secretary of the Treasury by his letters of September 20, 1965.

With kind regards, I am

Sincerely,

JOHN E. HORNE, *Chairman.*

NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS,
Washington, D.C., June 2, 1966.

MR. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: We have given careful study to your proposed legislative approach to the problems created by commercial bank issuance of certificates of deposit, as outlined in your letter of May 31.

As you know, the widespread issuance of small denomination CD's bearing interest rates up to 5½% on funds invested as little as 30 days is producing destructive competition in savings markets with immediate adverse effects upon home building and home financing operations throughout the nation. The League believes that abuse of the CD instrument by these banks will ultimately prove detrimental to commercial banking and indeed the whole financial structure of the nation.

For a long time, the League has favored the imposition of limitations on bank certificates of deposit to cool off the war which has developed among financial institutions for savings funds. In our testimony before the House Committee on Banking and Currency last month, the National League offered the following recommendations:

"We would urge that consideration be given to a redefinition of a 'time deposit' to give recognition to the fact that 'demand' and 'time' deposits are different and require a time differential of more than 30 days. A six or nine month differential would be desirable. The issuance of 'savings bonds' or 'savings certificates' at rates higher than the rate ceiling on savings accounts should be terminated. Finally, the League would urge this Committee to take whatever action is necessary to prevent Regulation Q from being used to create chaotic destructive competition in the nation's money markets and the accompanying adverse impact on home financing operations."

We also coupled these recommendations with a suggestion that your Committee might wish to make a full scale study of the legislative tools—including broader investment powers—that thrift institutions require to meet sharply intensified competition from commercial banks.

The three-point legislative approach suggested in your letter is in accord with the recommendations of the League.

Your letter proposes a 4½% rate ceiling on time deposits below $100,000 and a permissible rate up to 5½% on such deposits in excess of this amount. It is important to point out and emphasize the fact that in most communities of the nation, thrift institutions are paying rates on savings of 4½% and *less*. Although rates are higher in the far west, there are many communities in the middle west and east where thrift institutions are paying 4¼% and some continue to pay at the 4% rate.

Therefore, a maximum bank rate of 4½% on time deposits of less than $100,000 could have the effect of increasing rates paid at numerous institutions and precipitating further chaos in savings markets although such action may not be intended. We urge that your Committee consider the possibility of establishing the rate ceiling on time deposits under $10,000 at 4¼% with a minimum six month maturity.

The League is not conversant with the liquidity reserve requirements of commercial banks and, therefore, would not be in a position to comment on the merits

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of the proposal to increase these requirements on time deposits. In this case, we would defer to the Committee and other students of the banking system to determine the merits of this proposal.

Thank you for this opportunity to present the views of the League on this vital matter. Needless to say, we would urge the Committee and the Congress to act speedily on proposed CD legislation inasmuch as there is likely to be a substantial drain of savings funds from thrift institutions again in July if present conditions persist.

Sincerely yours,

HARRY P. GREEP, *President.*

THE AMERICAN BANKERS ASSOCIATION.
New York, N.Y., June 3, 1966.

HON. WRIGHT PATMAN,
Chairman, Banking and Currency Committee,
U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In a letter dated May 31, 1966, and received by us on June 1, 1966, you have requested our comments on three new proposals designed to reduce competition among banks, and between banks and the so-called thrift institutions, for the savings of the public. I am sure that you understand that in the brief time available it is difficult to provide a detailed analysis of these proposals. Nevertheless we have attempted to set forth below our reactions, and we would like the opportunity to supplement these views upon further consideration.

Before commenting on the specific proposals, we would like to make several general observations. While we do not dispute the fact that the home building industry is of great importance to our economy and may be suffering from a shortage of funds, we must emphasize that this is also the case with many other sectors of our economy. This is inevitable in a period when we have relatively full employment of human and physical resources combined with a conscious effort on the part of the monetary authorities to prevent inflation. If the Congress decides it is essential to aid the home building industry—as well it might—then this is best done by taking specific steps which will directly benefit this particular segment of our economy, such as increasing the amount of funds available to FNMA. It does not seem to us appropriate to attempt to achieve a worthy objective by discriminating against an industry such as commercial banking which serves the needs of all borrowers—including home purchasers. Indeed I should point out that commercial banks in many parts of the country are just as eager to obtain funds to lend to home owners and the construction industry, as well as to other important borrowers, as are savings and loan associations, but banks are facing many of the same difficulties as are the mutual thrift institutions.

There is another underlying assumption which appears to be contributing to the concern held by you and the members of your Committee and on which we would like to comment. This is the belief that all of the funds lost by savings and loan associations and mutual savings banks are moving to commercial banks. It cannot be too strongly emphasized that all institutions seeking funds to lend, as well as all borrowers, are experiencing difficulties arising out of the fact that we are attempting to maintain our economy at full employment levels and still avoid inflation. In all of the concern over the reduced inflow of funds to the mutual thrift institutions, it is sometimes overlooked that commercial banks also are faced with a severe reduction in new funds. For example, in the first four months of 1966, savings and time deposits acquired by commercial banks were 33.5 percent below the amount acquired in the comparable four-month period in 1965, while the amount acquired through certificates of deposit was 35 percent less than the inflow from this source a year earlier. Much has been made of the fact that in the month of April withdrawals from savings and loan associations exceeded the new savings inflow by $744 million. These funds are obviously going to other sectors which are more attractive, but it is also obvious that the commercial banks are not the only recipients. In the same month, commercial bank savings and time deposits of business and individuals grew by only $129 million, down almost 70 percent from the growth in April 1965.

Reports we have received from countless banks—particularly those of small size—indicate that the higher rates offered by these banks on certificates of deposit simply enable them to retain, in the form of certificates, funds which

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were previously deposited in their own passbook savings accounts or in demand accounts. While some of the difficulties of the mutual thrift institutions are of course attributable to the increased competition from commercial banks, the basic problem lies in the fact rates generally have been moving upward, for reasons attributable to the pressures generated by a burgeoning economic system.

Turning now to the specific proposals outlined in your letter, we have attempted to appraise them first in terms of the principles which were set forth in testimony before your Committee on June 2, 1966. You will recall that our Association recommended that any action taken should be in accord with three principles:

1. It should not impede the orderly functioning of the nation's financial markets.
2. It should provide for equal treatment of the industries which compete for the public's savings.
3. It should provide for orderly and efficient administration of the statutes by the appropriate Federal authorities.

It is clear that not one of the proposals contained in your letter meets the second criterion, which we believe to be of particular importance. That is to say, in not a single case is there any indication that additional regulation will apply across-the-board, to all competing financial institutions. On the contrary, it is quite clear that only the commercial banks are to be subjected to regulation, apparently for the benefit of savings and loan associations and mutual savings banks. Accordingly, we find each of the proposals seriously deficient in this sense and, if for no other reason, would oppose any or all so long as no provision is made for providing a climate in which all financial industries can compete on an equal basis.

Although somewhat less serious, all three proposals fail to meet the third criterion which we suggested in our testimony: orderly and efficient administration of the statutes by the appropriate Federal authorities. You will note that with respect to your first proposal—involving an increase in reserve requirements against time deposits—the impact would fall only on member banks of the Federal Reserve System, leaving the majority of the banks in the country free from any restrictions.

Orderly functioning of the nation's financial markets—our first criterion—would be jeopardized by all three proposals to a greater or lesser degree depending on action by the Federal Reserve. That is, to the extent that any or all of these proposals are successful in diverting savings and time deposits from commercial banks to competing institutions, commercial banks will be faced with a need for a greater volume of reserves. This is because the funds diverted, for the most part, will simply reappear as demand accounts in commercial banks. As you know, these accounts require substantially larger reserve requirements. Therefore, unless the Federal Reserve is to make available additional reserves, or lower reserve requirements, the result will be a severe credit stringency and extremely tight money.

Several additional observations should be made with rspect to the individual proposals. The first, which would provide for increased reserve requirements against time deposits, is simply the equivalent of a tax on those commercial banks which hold time deposits and, more particularly, those commercial banks which issue certificates of deposit. This is because the proposal would require that an additional proportion of the funds obtained through such deposits be placed in nonearning assets (reserves), thus increasing the cost of these funds to the banks. We have serious question, on grounds of equity as well as those of good administration, whether a tax should be used to accomplish the objective which you have in mind, namely, to reduce the ability of commercial banks to compete with the mutual thrift institutions.

The proposal would obviously serve no monetary policy objectives and would not provide additional liquidity since reserves are not available to the banks for this purpose. Indeed, the legal reserve requirement is the principal tool given by Congress to the Federal Reserve to facilitate the performance of its monetary policy responsibilities, and it seems completely inappropriate to use this device to aid an industry which is thought to be in trouble. Moreover, because small and moderate size banks tend to have a larger proportion of their deposits in savings and time deposits, and small banks in particular rely on certificates of deposit in many parts of the country, the tax which is contemplated under this proposal would bear more heavily on small- than on large-sized banks.

The second proposal outlined in your letter suggest that no time deposit may have a minimum maturity of less than either one year or six months. This

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would appear to us to have some degree of acceptability—apart from the reservations expressed earlier. However, we would strongly recommend that if it is adopted the minimum maturity period be three months rather than six months. As you know, the Federal Reserve and the FDIC already have statutory authority to accomplish this objective, and as a matter of fact until recent years a distinction was made with respect to interest ceilings for time funds of various maturities. However, it should be pointed out that, like your first proposal, the impact is likely to be felt more by small banks than by larger-sized institutions. This is because the large-denomination negotiable certificates have an organized secondary market, so that even if maturities are lengthened purchasers may still be asured of availability of their funds on a shorter basis through sale in the secondary market. On the other hand, small banks which for generations have depended on certificates of deposit have no similar secondary market to which to turn so that, competitively, these banks will be placed in a relatively more disadvantageous position.

The third proposal contained in your lettter—that the maximum rate of interest payable on time deposits shall be 4½ percent for deposits of less than $100,000, whereas the present ceiling of 5½ percent will continue to apply to time deposits of $100,000 and over—may contain the elements of a workable plan for preventing competition of the type which can become destructive. However in its present form it is completely inequitable and therefore unacceptable. First, it establishes ceiling rates by statute, which means that it will be necessary to amend the statute whenever a change is required. Such amendments would undoubtedly be too late to prevent serious damage to banks and to the economy, particularly in situations where economic conditions are changing rapidly. Second, it makes no provision for comparable regulation of savings and loan associations and mutual savings banks. To establish by statute a ceiling on bank time funds while leaving unregulated the rates which can be paid by compeitive institutions is impractical and inequitable.

Obviously, the question of the appropriate point at which to differentiate by deposit size, as well as the ceilings which should be established. involves a careful balancing of sensitive factors. If such a proposal is to be seriously considered, we recommend that your Committee take final action only after it has had an opportunity to examine all relevant information—including the material soon to be made available by the Federal banking agencies. In addition, and more importantly, it is essential that authority for the establishment of ceiling rates be placed in the banking agencies—preferably in the Board of Governors of the Federal Reserve System—and that the agencies be given maximum flexibility in the implementation of this responsibility. Finally, we believe it to be of utmost importance that any regulatory authority designed to prevent destructive competition be equally applicable to all institutions competing for the public savings. As I said in the statement presented to your Committee, the basic objective should be the maintenance of a sound and strong financial system within the framework of which all industries can compete on an equal basis.

Let me close, Mr. Chairman, by assuring you that The American Bankers Association stands ready to support any constructive measure which will ease existing difficulties in the residential mortgage market and which will prevent undesirable competitive exesses.

Sincerely yours,

ARCHIE K. DAVIS, *President.*

UNITED STATES SAVINGS AND LOAN LEAGUE,
Chicago, Ill., June 1, 1966.

HON. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
Washington, D.C.

DEAR MR. CHAIRMAN: Your letter of May 31 is another indication of the constructive interest you and your Committee have shown with respect to the problem of certificates of deposit. We have previously expressed a number of steps that we felt would be helpful in dealing with the situation, but in the interest of brevity, I will comment here only on the specific questions you have raised.

We would favor a 4% to 10% reserve range as indicated in your paragraph 1(b). This would leave the Federal Reserve considerable leeway. It would not make a change from the present 4% mandatory but it would encourage the

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Federal Reserve to consider setting the rate higher as a mildly restrictive measure.

With respect to a minimum maturity, we would suggest six months, at least for amounts of $100,000 or less. It may be that some of the large corporations dealing in large sums may properly negotiate a shorter maturity. These large sums are not savings and we are just not experts on what the maturities should be.

The $100,000 minimum described in paragraph 3 would be extremely helpful in eliminating chaotic competition for savings. It would be the simplest and most effective way of preventing banks from using certificates of deposit as disguised savings accounts. This is the practice that is creating the great drain of savings away from thrift institutions and the mortgage market.

The $100,000 floor would still permit banks great flexibility in competing for the large CDs held by corporations. It is these larger denominations that constitute the bulk of the dollars that go into certificates.

I am sure your Committee understands, of course, that the big savings turnover period begins in just four weeks. Thus, any legislation to be effective must be enacted quickly.

We are confident that your Committee will take timely and appropriate action.

Sincerely,

NORMAN STRUNK, *Executive Vice President.*

The CHAIRMAN. We will discuss these replies and it is anticipated we will probably not have a hearing until Tuesday morning. We will have a meeting Tuesday morning and at that time we will probably study the replies with the whole committee and then, Wednesday morning we would like to have Mr. Martin, Chairman of the Federal Reserve Board, who has not testified on this matter and Mr. Fowler, Secretary of the Treasury. Since the proposal that is now before us is so different from what Mr. Fowler first proposed, we would like to have his views, too, and after that, unless something unforeseen comes up we will expect to close the testimony. Is that correct, Mr. Widnall?

We will close the testimony and probably vote on Thursday. We will do it then if we cannot do it before.

Thank you, gentlemen, very much for your appearance here. We appreciate your testimony and it has been helpful to us. It will be carefully considered.

(Whereupon, at 12:10 p.m., the committee adjourned, to reconvene subject to the call of the Chair.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

TUESDAY, JUNE 7, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Moorhead, Stephens, Gonzalez, Minish, Weltner, White, Gettys, Todd, Ottinger, McGrath, Widnall, Fino, Halpern, Johnson, Stanton, and Mize.

The Chairman. The committee will please come to order.

Our witness this morning is the Honorable Joseph W. Barr, Under Secretary of the Treasury. The committee continues its consideration of proposals to remedy a terrible situation created by the Federal Reserve Board which has resulted in a disastrous rate war among financial institutions. The successive changes in regulation Q over the years, particularly since 1964, are at the bottom of the rate war. Because of the Federal Reserve tight-money policy to keep interest rates high, it has not supplied sufficient reserves to permit banks to create demand deposits to serve their customers' needs. Therefore, they have encouraged the commercial banks through regulation Q to engage in rate wars with thrift institutions and attract new time deposits at the expense of the thrift industry. Actually, this has been going on for nearly 2 years.

So the Federal Reserve is determined that, if anybody is going to have sufficient funds for loans, it will be the big banks, even if everybody else has to suffer, especially the housing industry.

Everybody recognizes that the large money-market banks are overextended with loan-deposit ratios of 80 percent, with stock market loans up 60 percent over 1960, and with overreliance on interest-sensitive corporate funds for their liquidity.

The month of June is indeed critical both to these commercial banks and to the thrift industry as the Fed's tight-money squeeze continues. The thrift industry is faced with a July 1 dividend date, while the commercial banks face the problem of renewing over $4 billion of negotiable CD's just in June alone. This $4 billion figure exceeds even the amount of CD's the banks wanted to renew last December when the Federal Reserve raised regulation Q so drastically. This liquidity squeeze the banks find themselves in—even though some consider it a money-market crisis—is no excuse to raid the assets of thrift institutions, particularly when the housing needs of the American peo-

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ple are so great. The Federal Reserve is without question acting contrary to the intent of Congress when it enables the New York banks to shift their own liquidity problems to the thrift industry. The Home Loan Bank System cannot provide free reserves to savings and loan institutions as the Federal Reserve can to commercial banks. They are at a disadvantage. It should also be remembered that the Federal Reserve Board did not even consult, much less coordinate, with the Federal Home Loan Bank Board before raising regulation Q last December.

Instead of declaring a rate war for time deposits, the Federal Reserve should have increased reserves for additional demand deposits. There has been too little growth in demand deposits over the years.

To claim that the Federal Reserve was as surprised as everyone else at the drain on thrift institutions is pure poppycock. After all, they were certainly aware of the aggressive compaigns for consumer time deposits many banks commenced after November 1964.

Mr. Barr, you have been asked to comment on a proposal by Mr. Widnall and myself, (1) limiting the rate ceiling to 4½ on all time deposits, but permitting indefinite renewals of outstanding deposits at the current contract rate; (2) making eligible for open market purchase by the Federal Reserve System guaranteed obligations issued by the Federal home loan banks; (3) increasing the required reserve range on time deposits to 4 to 10 percent from the present 3 to 6 percent, and increasing the minimum maturity on time deposits from the present 30 days to 90 days.

In commenting on that 4½ percent, I wish you would comment, too, on what the effect would be if we made the 4½ percent rate clear across the board—in other words, from top to bottom—without reference to a $100,000 breakoff, and permitting the banks to roll over existing CD's at the current rates.

In other words, they would have to lose them as long as they renewed them then the new rate would not apply.

STATEMENT OF HON. JOSEPH W. BARR, UNDER SECRETARY OF THE TREASURY

Mr. Barr. Mr. Chairman, I received the questions you mentioned late last evening. I do have a prepared statement, although it does not go directly to your questions, Mr. Chairman, because it was prepared before I received the questions. However, I would be delighted to answer them later.

The Chairman. You may handle it as you desire.

Mr. Barr. Yes, sir.

Mr. Chairman and members of the committee, in his testimony before this committee on May 19, the Secretary of the Treasury reviewed recent developments with respect to competition for time and savings deposits.

In appearing before this committee today, it is not my purpose to indicate a change in analysis or a change in the Treasury's position. The Secretary's position, which was essentially restated in his letter to the chairman on June 2, 1966, stands. Indeed, against the background of statements made by many others since then, I believe his comments and his constructive suggestions remain sound and con-

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structive. However, in light of subsequent testimony and proposals, I welcome this opportunity to make additional comments in this important area.

Without reviewing recent developments at any length, let me just note that savings and loan associations and mutual savings banks have encountered increased competition from commercial banks during the past few days. This competition has been intensified with recent interest rate increases and the December 1965 revision of regulation Q.

Thus far in 1966 we have seen a substantial reduction in the inflow of savings into savings and loan associations and mutual savings banks. During the first 4 months of 1966 savings shares at S. & L.'s increased by only $500 million compared with an increase of $1.9 billion during the similar period in 1965 and $2.8 billion in 1964. During the same period—the first 4 months of 1966—there was a $500 million inflow into mutual savings banks compared with $1 billion in 1965 and $1.3 billion in 1964. An important factor in this smaller net inflow, apparently, is the outflow of volatile, rate-sensitive funds to commercial banks and into market instruments.

I should like to emphasize this point particularly, because it is important to keep in mind here that we are dealing with a matter of rate sensitivity and not one of weakened confidence in the soundness of our financial institutions. Savings and loan associations, for example, can count on substantial flows of repayments from existing mortgages, as well as access to home loan bank borrowing to meet potential outflows of savings. We would certainly not regard large outflows with indifference, however, as they would tend to reduce new mortgage loans made by S. & L.'s and hurt the homebuilding industry.

Turning to some specific proposals that have been offered, limitations on the use of large denomination negotiable CD's would take away a major source of funds for large banks. Such CD's are not competitive with S. & L. shares or mutual savings bank deposits to a significant degree. Placing restrictions on the use of negotiable CD's would, I believe, result in little, if any, benefit to S. & L.'s, the mortgage market, or the homebuilding industry.

It is the smaller denomination CD, or savings certificate, that competes most closely with S. & L. shares or deposits in mutuals. Restrictions on terms that banks may offer on such CD's would tend to arrest the outflow of funds from S. & L.'s to banks. With this in mind, the Secretary of the Treasury proposed that the Federal Reserve Board be given temporary authority to set a lower ceiling on the insured portion of time deposits. That proposal provides a sound basis for offering a lower interest rate on smaller denomination time deposits, since the lower rate would be limited to the riskless portion of the deposit.

Mr. Chairman, I would like to interpolate some information that I discovered last night, after I prepared the statement—about the importance of this riskless portion of the deposit. I would like to call your attention and the attention of the committee, that since you have been in the Congress of the United States, Mr. Chairman, since late 1928, I believe is the date, when you came to the Congress of the United States, 10,400 commercial banks have failed in this country—with $7.9 billion of deposits.

Now, I realize that the Congress and the country has reversed the position that prevailed in the past. But I would submit to you and to

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this committee that the only way to get a riskless deposit is with the guarantee of the United States. And with that record behind us, I think it is an important consideration, especially for the small saver.

Since the Secretary spoke to this committee, others have suggested that a lower ceiling on the first $10,000 would not affect a sufficiently large proportion of volatile savings deposits. A case could be made for drawing the line at a higher level—somewhere in the range of $25,000 to $100,000—and we would enter no objection to making the distinction somewhere in that range, although we did, and still do, see a logic in tying any lower rate to the insurance coverage.

Secretary Fowler strongly suggested a ceiling rate of 5 percent on smaller time accounts. Such a rate, we believe, would not necessitate a larger rollback by many banks. Combined with recent action by the Federal Home Loan Bank Board, it would diminish the tendency to shift funds from S. & L.'s and mutuals into commercial banks, although it would not result in any reversal of shifts that already have occurred. A lower ceiling, say 4½ percent, would penalize smaller savers, would place banks at a disadvantage compared with savings and loan associations in many parts of the country and would substantially increase the relative attractiveness of direct security purchases to individual investors. Such a rollback in the rate ceiling could have a substantial adverse effect on bank liquidity without affording a corresponding gain to S. & L.'s.

I strongly believe that any ceiling placed on rates banks can pay on smaller CD's should be temporary and that legislation along these lines should expire after, say, 1 or 2 years so that Congress and the administration can reappraise the situation. In the long run the public will benefit from competition among financial institutions and, consequently, it is important that we avoid permanently establishing anticompetitive rules governing the operation of financial institutions.

Viewed in perspective the present situation reflects economic relationships that have developed in the recent past and may recur from time to time in the future. Monetary tightness and high short-term interest rates can be expected, at times, to pull funds away from savings institutions and the mortgage market. The current situation is complicated by the fact that restrictions on interest payments on bank time deposits were recently relaxed and this return to a more competitive situation will require some adjustments by savings and loan associations, including the loss of some rate-sensitive funds. It is this temporary adjustment that is our present concern. I believe it would be inappropriate to deal with such a temporary adjustment by imposing permanent restrictions on competition for time and savings deposits.

Several suggestions have been offered to this committee regarding changes in reserve requirements. In his testimony, Secretary Fowler suggested the possibility of giving monetary authorities greater discretion in imposing reserve requirements on negotiable CD's that might exceed those on other time and savings deposits. Other, rather specific, proposals have been offered which would raise the level of reserve requirements on time deposits or on CD's. Implementation of such proposals could have important implications for the competitive relationship among financial institutions and the functioning of mone-

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tary policy. It would be desirable for action on any such proposals to be taken only in the light of the most careful and objective analysis. While I believe that there are fruitful opportunities for improving the techniques and tools at the command of the monetary authorities in this area, I do not believe that implementation of these proposals would provide any immediate benefit to savings and loan associations or to the homebuilding industry.

In concluding, I would like to commend the chairman and this committee for tackling a very difficult subject and attempting to hear all sides of the several issues involved. While these hearings were prompted by some real problems, I would urge the committee not to react to the problems at hand by creating still greater problems.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Barr.

Now, on the question of the CD's—I believe you said if we were to adopt a rate of 4½ percent clear across the board, irrespective of any cutoff, up to $100,000, that that would cause a liquidity problem among the large banks. Is that correct?

Mr. BARR. I think it would probably cause a liquidity problem, Mr. Chairman. Frankly, we don't know where these funds would go. We think they would probably move out of the banks into market instruments causing, as you point out, a liquidity problem. But I would also like for the record to show that such a move would give us grave concern in the area of balance of payments.

For the first quarter of this year we had a net reflow from foreign countries back into our own banks.

The CHAIRMAN. Mr. Barr, I might just as well say now that I don't like to hear this balance-of-payments business come up in everything that is proposed to help the people.

In the first place, I am not too patient with that argument. I might as well tell you what I think about it.

I don't think there is anything wrong with the balance of payments that proper controls of export capital would not cure. I believe you will have to admit—and I know you will be glad to, because it is a fact—that our country is the only country on earth that doesn't impose export control on capital. Is that correct?

Mr. BARR. We have very few, if any, controls, Mr. Chairman. Most countries, as you stated, do have formal or informal controls on the movement of money.

The CHAIRMAN. Export of capital. Therefore, we have a remedy for that, if we want to exercise it. There is no question about it. So why bring it up every time? We can cure that on its own. So let's don't bring it into every question that comes up. And this one certainly is an important one.

The liquidity problem, if one were to arise, could be completely cured by permitting the banks to keep these CD's at the increased rate—the 37½ percent increase of December last year that was granted to them by the Federal Reserve System—let the banks keep this high rate on all existing CD's until they just run out in 1 year, 2 years, 10 years, that is all. Wouldn't that cure that particular part of the possibility of liquidity squeeze?

Mr. BARR. Mr. Chairman, we have looked at this very closely, and we do not think it would. I will tell you why.

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Corporations, for example, buy CD's in the fall to get ready for their tax payments that come due in December and the next tax payment that comes up in March, and another one that comes up in June, so it is an in-and-out market. For instance, on June 15 corporations will be running down their total amount of CD's to pay their taxes to the United States. Then in the following month and subsequent months, they will be replenishing their balances and coming back into the market. So it is an in-and-out market. It is difficult to say that you are at one level all the time.

I think individuals have somewhat the same problem, Mr. Chairman. We notice that in the April outflow from mutual savings banks and savings and loans, a large amount went to pay taxes, some of it went to the stock market, some of it went to municipal bonds. But they move back and forth in this area.

So it is for this reason that we have serious doubts as to whether or not this proposal would avert a liquidity squeeze on the banks or, for that matter, the mutual savings banks, and the savings and loans.

The CHAIRMAN. But you are assuming we must respect these CD's, we must continue the CD in its present use.

Isn't it a fact that in this Operation Twist, I believe it was so called by Mr. Dillon and Mr. Martin, that there was a deliberate effort made by the Treasury and the Federal Reserve to increase short-term Government security rates?

Mr. BARR. That is correct, Mr. Chairman.

The CHAIRMAN. Now, I consider that a conspiracy against the public interest, and I said so to Mr. Martin, I said so to Mr. Dillon. Right here in the United States of America, a country run by the people, through their elected representatives, and Government officials, one elected and one appointed by an elected official, who get together and actually make arrangements to force up Government interest costs. I think that is terrible, I think it is awful, and I think that it should not be tolerated.

In 1941 to 1945, during World War II, we paid a very low interest rate for short-term securities. That is when we had a Federal Reserve Board that was working in the people's interest—instead of working in the interests of the banking institutions. And we paid in 1941, for instance, a thousand dollars for a sum of money for a definite length of time, according to the short rates on Government securities at that time. Today that same money costs us $40,000—just think, $40,000. None can deny that. It is the truth and the records show it.

I think it is wrong. Right now we are paying a 5-percent rate, instead of paying a low rate on short-term securities by getting it from the Federal Reserve if necessary, as we did during World War II.

Now, I don't think that could be justified in any country on earth. Do you know of any other country that pays a 5-percent rate on 90-day bills?

Mr. BARR. Yes, sir. The Eurodollar rate today is 5¾ percent.

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The CHAIRMAN. You mean for short-term 90-day bills?

Mr. BARR. Yes, sir.

The CHAIRMAN. Euro-dollar bills?

Mr. BARR. Yes, sir.

The CHAIRMAN. Well maybe so. But that doesn't make it right. Two wrongs don't make a right.

Mr. BARR. No, sir. The pattern of interest rates in the world today is very, very high, Mr. Chairman.

The CHAIRMAN. Yes, sir.

I will have more to say about that, but I yield to my colleagues now. Mr. Barrett.

Mr. BARRETT. Just a very short question, Mr. Chairman. I would like to ask the distinguished gentleman, a former member of our committee, about the remarks on page 5 of the statement in the next to the last paragraph—

> I strongly believe that any ceiling placed on rates banks can pay on smaller CD's should be temporary, and that the legislation along these lines should expire after 1 or 2 years.

I have always been of the opinion the most permanent thing is a temporary situation. And this may enter into one of the most permanent situations that we have ever put on the statute books. This seems to be a very unusual thing to do in such a serious situation.

Mr. BARR. Mr. Barrett, I quite agree that many temporary solutions do turn out to be permanent. I agree this is a very serious situation. However, times change, and what is an answer one day may not be an answer the next day.

The only thing I am suggesting, Mr. Barrett, is because this is a very complex and difficult situation, that we don't lock the country in forever with a solution that we would arrive at today, and that we use the time-tested device of the Congress, of meeting the problem as it exists, and then coming back and taking another look at it, and make a determination at that time whether or not you would like to continue the authority, whether you would like to change the authority, or whether you would like to abolish the authority.

It is a serious issue, Mr. Barrett, and I think it is one that should come up for scrutiny constantly.

Mr. BARRETT. Thank you.

The CHAIRMAN. Mr. Widnall.

Mr. WIDNALL. Thank you, Mr. Chairman. Mr. Secretary, I don't quite follow your argument or your statement in connection with the corporate use of CD's.

Mr. BARR. Yes, sir.

Mr. WIDNALL. If this were happening to the extent you say it does, where they go into the market for 2 or 3 months purely for tax purposes, wouldn't there be quite a fluctuation in the amount of CD's up and down? It seems to me from the charts I have seen, we have a continuous rate in CD's outstanding, but nothing going down.

Mr. BARR. There is usually a drop of around a billion dollars around the tax dates, Mr. Widnall. I use that as an illustrative example. Of course, you are correct. The trend, since 1961, has been that corporations—I think they are the largest investors in this area—have put more and more of their available cash into these instruments as investments.

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I was addressing myself to question No. 3 in the letter that I have received from the chairman, which asks this question—"Lower the maximum interest rate payable on time deposits from 5½ to 4½, but permit renewal of all presently outstanding deposits at the contract rate."

The point I am making is that there is an in-and-out movement of these funds—it doesn't stay stable. That is the reason that I do not believe it would avert what could be some sort of a liquidity crisis in banks.

Mr. WIDNALL. Well, every tax date the banks have a problem of meeting a billion dollars in connection with certificates of deposit. How are they meeting that billion dollars at the present time?

Mr. BARR. They don't have to roll them all over, Mr. Widnall. I think at the moment many of the larger banks are retrenching. They are pulling back their loan policies. They are accumulating the cash that they are probably going to need this month.

The chairman pointed out there is going to be $4 billion that they have to roll over this month. They have to make an estimate as to whether they can renew this $4 billion, and if they cannot, they are going to have to get the liquid resources to pay off what they cannot renew.

The charts you refer to do show a very steady growth, but they show only the end of year balances. They do not show the variation from bank to bank, and they don't show the variations, especially at tax dates, Mr. Widnall.

Mr. WIDNALL. Well, if you could devise something in connection with the existing CD's, and then you could cut off the use of CD's, it seems to me it would take care of the liquidity problem, and at the same time discourage the further use of CD's at a high interest rate. This is what we are talking about.

Mr. BARR. Mr. Widnall, I think the line that I seem to detect in this committee, and the one that I have discussed with several members, is that what they are trying to do is recognize that there are two markets in the United States. One market is essentially a local market, which has been used historically for savings and for homebuilding. There is another large national market with volatile flows of funds that move across the country, and also move in international commerce. The latter is a horse of a different color.

Now, what I am saying here is that I think that you cannot isolate this domestic market without serious damage some place in this area from $10,000 up to a hundred thousand dollars. And if you want to build in a differential, as you have suggested, we think that a differential at around 5 percent makes more sense because there would be less temptation to roll out of CD's at this rate than there would be at 4½ percent.

Municipal securities now pay a very handsome return. Our Government securities, as the chairman has pointed out, in the 1 year area are paying around 5 percent.

There are many opportunities that exist across the board which I think would cause troubles for many banks if they were pulled back too far. And I especially think that in the area above a hundred thousand dollars—although the chairman has indicated he doesn't like

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to have the balances of payments discussed—nevertheless it is a fact we have to live with it. As long as we are going to keep 250,000 to 300,000 men in Vietnam, as long as we are going to keep our ships at sea, we are faced with exchange costs. And unless we are to make a radical change in this country, and really throw on controls that I think would be damaging, I don't see how we can get way from the balance-of-payments question. That is the reason I think the differential area makes good sense, not only for the country and the thrift institutions and homebuilding, but I think it also makes good sense, because it leaves alone the great volatile flows that we must concern ourselves with.

Mr. BARRETT. Will the gentleman yield?

Mr. WIDNALL. Yes.

Mr. BARRETT. I just want to ask the gentleman this. You indicated just a few minutes ago the number of bank failures in the United States. Would you tell us that number again, and over what period, please?

Mr. BARR. Yes. Actually, this is not a very fair use of statistics. The chairman of this committee came to the Congress at a time of financial crisis. He has probably had more experience in this area than anyone else. The figure was 10,400. But most of these failures occurred from 1928 to 1934. After that date, I would think maybe there were 100 to 150 bank failures. I don't have the precise figures; 10,400 banks failed from 1928 to date—and the total amount of deposits was $7.8 billion.

Mrs. SULLIVAN. Lost?

Mr. BARR. No, ma'am, they were not all lost. A good part of those funds were recovered. But the banks were closed as insolvent, and they had to wait to get their funds.

Mr. BARRETT. This may not be an easy thing to do, but I was wondering if any of your staff members would be able to tell us the number of bank failures in each of these years?

Mr. BARR. We can supply that for the record very easily, sir.

Mr. BARRETT. Would you be able to tell us—excluding poor management—what caused the failures?

Mr. BARR. The statistics in those early days, Mr. Barrett, were not very good, and I don't really think they did know what caused many of these failures. I will defer to the chairman who probably knows more. But they were failing at the rate of 2,000, 3,000, 4,000 a year in the very bottom of the depression. I think it was the depression, the great drop in the value of assets, that caused most of the failures, and the fact there was no deposit insurance.

Mr. BARRETT. Thank you.

(The following material was submitted by the Treasury Department:)

Attached is a table showing the number of bank failures by years from 1928 through 1965. It is not possible to supply a similar breakdown indicating the reasons for these bank failures. However, some general observations are possible. The largest number of failures occurred in the early 1930's and were obviously related to the collapse of economic activity throughout the country. In this period even sound, well-managed institutions failed in large numbers. By contrast, probably no recent bank failure can be attributed to general economic depression, although depressed conditions in localized areas may have contributed to a limited number of bank failures since World War II. In the last ten years bank failures can be almost exclusively attributed to mismanagement and/or dishonesty.

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Number of banks closed because of financial difficulties, 1928–65, by years

Year	Total	Insured	Non-insured	Year	Total	Insured	Non-insured
1928	499			1947	6	5	1
1929	659			1948	3	3	
1930	1,352			1949	9	5	4
1931	2,294			1950	5	4	1
1932	1,456			1951	5	2	3
1933	4,004			1952	4	3	1
1934	61	9	52	1953	5	4	1
1935	32	26	6	1954	4	2	2
1936	72	69	3	1955	5	5	
1937	83	76	7	1956	3	2	1
1938	80	73	7	1957	3	2	1
1939	72	60	12	1958	9	4	5
1940	48	43	5	1959	3	3	
1941	16	14	2	1960	2	1	1
1942	23	20	3	1961	9	5	4
1943	5	5		1962	3	1	2
1944	2	2		1963	2	2	
1945	1	1		1964	8	7	1
1946	2	1	1	1965	9	5	4

Source: Prior to 1934 data are taken from "Historical Statistics of the U.S. Colonial Times to 1957." From 1934 to 1964 data are from the 1964 Annual Report of the Federal Deposit Insurance Corporation. Figure for insured bank failures in 1965 supplied by Federal Deposit Insurance Corporation.

Mr. WIDNALL. Mr. Secretary, I have a bill in to increase the FNMA borrowing authority, which stretches it to $1,100 billion—a bill which would alleviate some of the problems at the present time by increasing the ability of the secondary market.

Would you care to state your opinion on this.

Mr. BARR. Mr. Widnall, the administration is looking at this at this moment. I must say that from the first look it seems to have merit. I would like to defer to my colleagues, especially in the Bureau of the Budget since your bill has a budgetary impact. At first blush it does seem to have merit, particularly the fact that it is a direct, open and above-board manner for the Congress to supply funds for the home-building industry if it determines it should be used.

I think there are reservations. I cannot state the administration's position yet, because it is not formed. It is still being worked out. I just wanted to indicate that the proposition does have merit. We don't want FNMA to lose complete touch with the market. It was designed to be in touch with the market, to reflec the market. We don't want to remove that—we don't want to put a permanent crutch under it. But from the first look, your proposal certainly has merit.

Mr. WIDNALL. That is all, Mr. Chairman. My time is up.

The CHAIRMAN. I would like to make this observation before you report on Mr. Widnall's bill.

Mr. BARR. Yes, sir.

The CHAIRMAN. A few years ago, back in 1957 or 1958, I believe, the law was passed which permitted private investors to invest in stock in FNMA. When was that?

Mr. BARR. I am not an expert on FNMA, Mr. Chairman.

The CHAIRMAN. Anyway, it was several years ago—1954. Now, then, there are a lot of private investors—around half of the stock owned by private and half by the Government— that is, after the Government put up the original capital.

Now, the first thing I want to consider is whether or not this would be a windfall to those private investors on Government capital, if

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you were to allow them to take a billion dollars and extend credit of $10 billion—in other words, create 10 times as much money as the marginal reserve. Keep that in mind, too, as to whether or not you want to do something to FNMA in the way of purifying it so it would be in the public interest instead of the interest of a few investors. So keep that in mind in making your report.

Mrs. Sullivan?

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Mr. Barr, do you believe if the insured deposits were raised from a limit of $10,000 to, say, $20,000, this might encourage depositors to leave their money in a savings and loan and perhaps stop them from shopping for higher rates?

Mr. BARR. I think, Mrs. Sullivan, there is a distinct awareness of insurance limits on the part of the American people. Some people are very concerned about putting a deposit in a commercial bank, or taking shares in an S. & L., in excess of the insured limit.

We do have a bill which is currently pending before the Congress in which the administration recommended that the insured limit be raised to $15,000. Of course, with that bill, with the sugar, goes some sour—we are also recommending that the Home Loan Bank Board be given the authority to set maximum rates on dividends that the S. & L.'s can pay, and we have certain conflict-of-interest provisions in this bill.

The administration does agree, Mrs. Sullivan, that an increase in the insurance level is warranted—and has been warranted now for a couple of years.

Mrs. SULLIVAN. Are we ever going to get the interest rates down again to 4 or 4½ percent on home mortgages without a serious recession?

Mr. BARR. Mrs. Sullivan, that is a difficult question to propound to the Treasury. The Treasury has a flat rule that they never predict the course of interest rates—they won't predict what rates will be an hour from now.

But let me put it in context.

Of course we can get interest rates down even if we have a booming economy, such as we have now. It is within the prerogative of the Congress and the administration to carve out a special sector for homebuilding, in essence, to subsidize the homebuilding industry if you want to. We have subsidized many things in this country. In essence we have subsidized homebuilding, you could argue, since roughly 1935. For example, a special area has been carved out for the savings and loan and mutual savings banks. They were given special tax advantages and paid almost no taxes until 1962. They were given an opportunity, or the right, to pay higher interest rates on savings than the commercial banks. In effect, from 1935 on, a special place has been carved out for the thrift institutions and for homebuilding.

Now, this situation was upset in December of 1965 when the Federal Reserve Board did permit commercial banks to pay a higher rate than the savings and loans either would or could pay.

So that situation was reversed. But it can be brought back into line, as you say. I don't know if you can get them back to 4½ percent. That is driving back a long way.

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We have a prosperous and moving economy. If we are going to meet the demands ahead of us in many areas—mass transit, urban renewal, building colleges, pollution, and so forth—the capital demands on this country and the world are enormous.

I don't know that we can get back to that low level. But if the Congress decides it wants to do it, it can be done.

Mrs. SULLIVAN. In Secretary Fowler's appearance before this committee on May 19, he repeated several times in his prepared statement that we have here a temporary transitional problem—and it is not at all clear what the Secretary meant by this. And my own constituents certainly do not view it as such. This problem has been developing over a span of time, and unless a permanent readjustment is made, we might just as well close up our Housing Subcommittee.

Do you happen to know upon what concrete facts Secretary Fowler based his appraisal that the rate war is only temporary?

Mr. BARR. There are no concrete facts to indicate it is temporary or permanent. Secretary Fowler was expressing his best judgment, Mrs. Sullivan.

As I mentioned to you, there was this sudden rather abrupt shift in December when regulation Q was raised to 5½ percent, which permitted the banks to move quite a ways beyond what the S. & L.'s were paying. This was a sudden and dramatic shift in the history of this country.

I don't think these shifts are necessarily permanent. They depend upon many factors—such as how much restraint do we need in this country. They depend upon whether or not the Congress and the administration would think a tax bill is necessary. They depend upon the course of the war in Vietnam. They depend upon a whole host of circumstances that are placing demands upon this economy today.

Mrs. SULLIVAN. Well, this chart indicates that this is really a long steady trend.

Mr. BARR. The growth in CD's—that is correct. That is the reason I think, Mrs. Sullivan, there is merit—we have said this all along—I think the committee is on the right track, and I hope they pursue it. There is great merit in making this distinction between the local savings market that is traditionally in this country reserved for homebuilding—carve out that area, put a limit on the amount that can be paid for CD's, if you wan to do this—go ahead, I think this is the right move, because it will tend to insulate this area from the competitive forces that we are living with in this economy in many other areas—in the private area and the Government.

I strongly believe that if you broke that rate either at $10,000 or at a hundred thousand dollars, and said, "Look, 5 percent is as much as you can go," I think that you would take a significant step down the road to making sure that the thrift institutions stay alive and vigorous and viable, and that they in turn had the funds to supply the homebuilding industry in this country.

Mrs. SULLIVAN. I just wondered—could he have meant that the thrift industry will also be able to pay 5½ percent once the return on their own mortgage portfolios reaches 7 percent or more?

Mr. BARR. I am sure Secretary Fowler did not have that in mind, Mrs. Sullivan. That is a rather dismal prediction that we did not contemplate at all.

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I think there is a consensus in this country on homebuilding. I have lived with it all my adult life. It does have a special place in the political stability of the United States. I think there is a consensus on both sides of the aisle that is good for political stability. It is good for morality, it is good for the economy of the country. I think this is a judgment that we have made. I don't think that the Congress or the country is ready to abandon that consensus and put the price of the home out of the reach of the average citizen.

Mrs. SULLIVAN. Thank you, Mr. Secretary, my time is up.

Mr. BARR. I hope your committee will not go out of business.

Mrs. SULLIVAN. I would like to say to you, Mr. Secretary, you were an outstanding member of this committee when you served in Congress, and I think you are doing a fine job in your present assignment.

Mr. BARR. Thank you, ma'am.

The CHAIRMAN. Mr. Johnson?

Mr. JOHNSON. Mr. Barr, in your testimony this morning you seem to point out what is happening—the savings and loan institutions only received during the first 5 months of this year $500 million in new deposits, compared with $1.9 billion in the same period in 1965. For purposes of argument, granted that the CD's are unfairly competing with the S. & L.'s; the fact that the banks have now some $17 billion worth of negotiable certificates of deposit outstanding—is there anything wrong that the banks have done with this money—is there any real reason that you can present to us that we should say the banks are improperly using this $17 billion? For instance, have they invested inordinately large amounts of money in consumer paper that they get 12 percent on, where someday they might own a lot of TV sets, for instance, or have they prudently invested the money, so there is no criticism of the way the banks have handled this money?

Mr. BARR. Mr. Johnson, the banks have used the money in many areas. They have used it to loan to the industrial sector of the economy, to build factories, to expand production. They have used it to put an increasing amount of bank credit in farm loans. They have used a lot of it for consumer paper. They are actively competing in the area of consumer finance today, and I think it is a good thing, because competition tends to drive the rate down. They put some amount back in mortgages.

I would think mortgages have had a lower priority because of the tremendous demand rolling from industry to build new plant and new capacity. That is the principal place where this money has gone.

Nothing I am saying here is an indictment of the way the banks have used this money. I think it has been used for productive purposes.

I will say one thing again—if I may get back on the balance of payments. It has not gone overseas. It has been used for investment in the United States of America.

Mr. JOHNSON. Another question, then. In order to, let's say, not make this money so attractive in the hands of the banks—I notice in your testimony there is sort of an innuendo at least that perhaps we could raise, or you people could raise the reserve requirements on members banks for the money that they have represented by outstanding negotiable certificates of deposit. Do you think that that would be a tendency for a bank not to solicit that type of money, so that it would flow into the savings and loans?

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Mr. BARR. Well, this is something that we recommended to the attention of the committee.

The present reserve requirement, Mr. Johnson, is 4 percent on time and savings deposits. If a bank has a CD out at 5½ and you raise the reserve requirement one point, that means a five basis point drop in the return on that CD, which would make the CD that much less profitable for the bank. That would come out of earnings. A 2 basis point reserve increase would be a 10 basis point in yield. That would come out of the earnings. It might be that the idea has merit and that you should give the authority to the Federal Reserve Board to vary the reserve requirements on these large CD's.

Mr. JOHNSON. That would only apply to member banks. It would not apply to State banks who are not members of the system?

Mr. BARR. I have not examined that. It might work by extending it to the FDIC. I would suggest that you consult with them on that. It would, as you say, apply only to member banks.

Mr. JOHNSON. Just one more question, so that we understand the proposition of Mr. Fowler and apparently yourself in your testimony.

If we place a much lower ceiling on the interest rate on a negotiable certificate of deposit for deposits under $10,000, is the theory that investors would not buy CD's under $10,000, but we would take that money and put it in building and loans, because they would give 5½ percent on this money? Is that the theory back of your bill?

Mr. BARR. No, no, that is not it at all. The rate we suggest, sir—and it is only a suggestion—is that with a 5 percent limit you would establish a relative equality of competition between the two institutions. In other words, there would not be a flow from S. & L.'s into banks, nor would there be a flow of funds from banks into S. & L.'s. They would be competing on an equal basis.

Mr. JOHNSON. Well, isn't the whole idea right now to do something drastic really quick that will cause money to flow into the S. & L.'s, and away from the commercial banks?

Mr. BARR. No, sir; that is not the intent of the administration. I don't believe it is the intent of the committee. Maybe it is. I thought the problem was to stop the outflow, no to reverse the flow, but to stop it. The intent is to stop this hemorrhage that they had in April, and some people are concerned about in June and July—all of us are concerned about it.

Mr. JOHNSON. Thank you very much.

The CHAIRMAN. Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Secretary, do I understand your point to be that while you have no objection to raising reserve requirements, you do not think that it is a specific cure for the situation that we are now facing?

Mr. BARR. That is correct. I do not think it will cause an immediate slowdown in the use of the negotiable CD's. I believe—and I have checked this as closely as I could—that what would happen is that the banks would continue the 5½-percent rate probably at the present volume and take the loss in their earnings.

Now, eventually, Mr. Moorhead, I think it would be a valuable instrument that probably should be given to the Federal Reserve Board to let it control the situation in this way. As for the immediate application, I don't think it would have much of an immediate impact.

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Mr. MOORHEAD. Proposals that we have a lower ceiling on interest rates affecting the smaller man and a higher rate for the bigger man have unfortunate implications. If, however, we couple these with an increasing reserve requirement, this would tend to take some of the curse away from this discriminatory aspect of the legislation.

Do you think that this kind of a package would be manageable and helpful in the situation?

Mr. BARR. I think it would have the advantage, Mr. Moorhead, that it would combine a short-run solution, which I think would have some kind of an immediate impact, with a longer run tool that the monetary authorities can use to good purposes in the future.

Mr. MOORHEAD. Have you given any thought as to what range of reserve requirements might be for these CD's?

Mr. BARR. If I were advising you or your committee, I would say to start it at the present level, which is 4 percent—that is the level it is now.

Mr. MOORHEAD. I think the range is 3 to 6 percent.

Mr. BARR. The range is 3 to 6, and it currently is standing at 4. My advice to the committee would be to run it, say, from 3 to 10—I would think some place in that area—or 4 to 10, where it is now.

I would be reluctant to advise the committee to take the responsibility themselves, by legislation, to increase the reserve requirement on these certificates.

Mr. MOORHEAD. In advising the committee, would you give the Federal Reserve the opportunity to have different reserve requirements for CD's of different maturities, and differing sizes? In other words, you might have a lower reserve requirement for a 1 year CD than for a 3-months?

Mr. BARR. That is possible. Now, they can vary the rate ceiling, not the reserve requirement, by maturity. So what you would in effect be doing, Mr. Moorhead, would be bringing the reserve requirement authority that they currently have into line with their rate authority, so there would be a good precedent for the move you propose.

Mr. MOORHEAD. And you would think this would be advisable?

Mr. BARR. Yes, I think it would be helpful.

Mr. MOORHEAD. Because as the maturity decreases in length, the CD becomes closer to cash, or demand deposit, where the reserve requirements are higher than they are on the time deposits?

Mr. BARR. That is correct.

Mr. MOORHEAD. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Stephens?

Mr. STEPHENS. Mr. Barr, I want to see if I understand what you have said.

There has been a proposal that the certificates of deposit under $100,000 be limited to 4½ percent. Your suggestion is that there is no objection to the hundred thousand dollars limit, but that you prefer to see the 5 percent?

Mr. BARR. Yes, sir, Mr. Stephens.

Mr. STEPHENS. Is that in line with the authority that has been recently extended by the Home Loan Bank Board, to have a variable rate of 5 percent? In other words, what you are suggesting is to have just one interest rate?

Mr. BARR. In effect, that is correct.

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Mr. STEPHENS. And let institutions then compete on a service basis as to which one gets the money?

Mr. BARR. In essence this is the way banks have competed among themselves for the past 30 years. Banks have in effect not competed on the basis of rates. That authority was taken away from them in the Banking Act of 1933. Since then they have competed among themselves mainly on the basis of services. I don't see why the same thesis cannot be expanded to the competition between banks and S. & L.'s. That is in essence the proposal.

The reason for the 5 percent rate limit is to stop an outflow from the S. & L.'s, but in stopping that outflow from the S. & L.'s, not to create a liquidity crisis for the banks. In our opinion, we see no reason to distinguish between commercial banks and the S. & L.'s. If you limit rate competition on deposits up to something between the $10,000 and $100,000 level, you recognize that the market you are dealing with is a local savings market that has traditionally been reserved for homebuilding.

Mr. STEPHENS. The liquidity problem that you spoke about—let me see if I understand it.

There will be due shortly in these certificates of deposit a maturity of about $4 billion.

Mr. BARR. That is right.

Mr. STEPHENS. Now, last December roughly the same amount of certificates became due. They were not paid?

Mr. BARR. They were not what, sir?

Mr. STEPHENS. They were not paid.

Mr. BARR. That is right.

Mr. STEPHENS. It is currently not likely that the $4 billion that is coming up will be paid by the banks that hold them.

Mr. BARR. There might be a temporary dip some place during this month, as corporations pay their June tax installments.

Mr. STEPHENS. To take care of the things you are talking about like income tax installments?

Mr. BARR. Yes.

Mr. STEPHENS. But you are saying that if we should require those $4 billion in certificates to be paid, that we would have a problem in liquidity?

Mr. BARR. Yes. If it were impossible for the banks to renew these CD's, I think definitely they would be up against a tight squeeze.

Mr. STEPHENS. That tight squeeze would mean they would have to call in some of their loans they would have out, in order to have the liquidity they would be required to have.

Mr. BARR. That is one course of action. Of course, they can go to the Federal Reserve to borrow, too, but I would think that the first thing they would try to do would be to call some of their loans. That is correct.

Mr. STEPHENS. Well, now, let me go to another problem.

Federal agencies had authority to create the present situation. The present situation has been done by legal steps within the authority of the various agencies that deal with the financial problems of the Government. Well, now, don't those same agencies that created the situation also have authority to get us out of it?

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Mr. BARR. Mr. Stephens, this is one area where I do not think you can belabor the administration. These agencies are responsible only to the Congress of the United States. They tell us this every day, three times a day. I think you do have a point.

And I think they have, as I pointed out, twisted 30 years of history in the past 6 months. I think the Congress has an absolute right to say—all right, let's restore the position.

This is in essence what is behind all these proposals. You are telling them to restore this position that existed prior to December of this year. This is in essence what you are doing in many of these proposals. I think you have the right. Personally, I happen to be disturbed when situations like this occur without full debate. I mentioned this was a consensus arrived at over 30 years of history.

The consensus I believe exists on all sides of the aisle—of the special position of the thrift institutions, the special position of homebuilding. I do not think you can destroy that consensus and move away from it overnight without full debate like you are giving them right now.

You can tell them, Mr. Stephens—the Congress does have the power, I cannot tell the agencies—go back and straighten up this situation. The President cannot tell these agencies—go back and straighten up the situation. They are creatures of the Congress, responsible only to the Congress. They are not audited by anyone. You are the only people who can tell them to go back to straighten up and fly right.

Mr. STEPHENS. I appreciate your statement.

Why is it necessary for us to enact legislation to make the agencies correct the situation?

Mr. BARR. You do not need legislation. I think a resolution directing them to act will suffice. All these agencies have said that they are not responsible to the President, they are not responsible to the administration, they are responsible to the Congress, and they will act if the Congress directs them to act—but no other way.

Mr. STEPHENS. If we pass legislation?

Mr. BARR. Either by legislation, or a resolution, you can direct them to act. The power is certainly there.

In other words, I have always looked at these independent agencies in this area as carrying out the Congress' function to coin money and regulate the value thereof.

Now, that is your responsibility. It is not the agency's. It is the responsibility of the Congress. And they are discharging it for you. But in the discharge of that obligation, you can certainly tell them how you want it discharged.

Mr. STEPHENS. Thank you very much for helping me clarify some of the thoughts that have occurred to me.

But I want to get back to this idea that you have stated, which appeals to me, and that is if we put everybody on the same competitive basis, it looks to me as if the decision as—the decision whether we side with the banks or savings and loan could be avoided. As I said the other day, the impact has been on the economy, but the impact has also been on us in the political arm of the Government too.

Mr. BARR. I can sympathize, Mr. Stephens, with your predicament.

Mr. STEPHENS. Thank you.

The CHAIRMAN. Mr. Stanton?

Mr. STANTON. Thank you, Mr. Chairman.

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Mr. Barr—in answer to one of the questions, in regard to the rate of interest, you referred to item 3 in the chairman's letter to you of May 31.

Mr. BARR. Right.

Mr. STANTON. Does the Treasury Department have any comments to make in regard to questions one and two?

Mr. BARR. Yes, sir. Mr. Chairman, I would like to take this opportunity, if I may, to answer the questions that were raised—Mr. Stanton raised these questions. I would like to answer them now for the record.

Mr. STANTON. May Mr. Barr do that on his own time?

The CHAIRMAN. No, it will have to be on your time, if you ask him the question.

Mr. BARR. I would at some point like to answer——

The CHAIRMAN. He doesn't have any time himself.

Mr. BARR. My time is the committee's time, Mr. Stanton.

Question 1 was the possibility of increasing the range of required reserves on time deposits from 4 to 10 percent. The Department of the Treasury would have no objection to such an increase.

Question 2 inquired about the desirability of an increase in the minimum maturity on time deposits from the present 30 days to 90 days. We would have no great objection to such an increase, although its value in the current situation is not too clear. The 30- to 90-day limit is tolerable—if it got out to 6 months, I think it could cause us problems, as Secretary Fowler indicated in his letter the other day.

However, we would interpose no objection to 30 or 90 days.

On question 3—you didn't ask this—but on question No. 3 I indicated that we thought the rollover requirement would not work—that this could possibly cause liquidity problems for the banks.

Mr. STANTON. Your testimony today pretty well covered point No. 3. And that is why I asked about No. 1 and 2. I appreciate that very much.

Mr. Barr, there is a question of legislation of CD's before the committee, which is of great concern to the bankers as it is to all of us. Do you think the legislation on CD's is needed primarily because of the adverse effect on the S. & L.'s at the present time, or because of the adverse effect it would have on the homebuilding industry?

Mr. BARR. I think the root effect is the effect on the homebuilding industry. It has been the traditional area in which the thrift institutions have invested their funds. So I think this is the real root of the problem.

Mr. STANTON. That has been my understanding of why the committee is going into this. And then to help confuse this committee, Mr. Davis of the American Bankers Association—they went on to state that commercial banks in this country in the last 10 years have increased their residential real estate loans by $16 billion, which almost offsets the $17 billion that we have been talking about. This is a very confusing thing for this committee.

On the other hand, too, the S. & L.'s are asking for legislation that will allow them to use money they now have for purposes other than mortgages. This further confuses the issue.

Mr. BARR. Mr. Stanton, I can understand the confusion. The $16 billion mentioned as an increase in commercial bank investments in

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residential mortgages is correct. I think it is a desirable move on the part of the commercial banks to move into this area of homebuilding.

I think they should be in that area. It is part of their function. But I would like to point out that the S. & L.'s put almost 90 percent of their money, I would say, or nearly all their funds into the homebuilding industry. So that is the distinction.

Now, as to the authority of the S. & L.'s to move into other areas, this is a question that should be examined. Putting on my other hat now, as a tax man, I would say before they get the authority to move into other areas, they should start paying some taxes. If they are going to be on the same lending basis as the banks, they should pay the same taxes as the banks.

Mr. STANTON. Mr. Barr, our chairman commented with regard to Mr. Widnall's bill. I cannot help but comment that this certainly would be a great shot in the arm to the homebuilding industry, and I hope the Treasury Department takes that into consideration.

The other question I had was in regard to your thoughts that anythink we should do should be on a temporary basis. The only thing that bothers many of us on this committee about this is that every time we institute temporary restrictions they tend to become permanent. Can you tell us of a restriction where this has not been the case?

Mr. BARR. That is a very good point. I quite agree. A temporary restriction does tend to have a permanent cast to it. But I think there is a great advantage, if you will permit me, sir, in the temporary approach of this Government to problems. We have a temporary approach on appropriations. There are many ways of making decisions in this Government. We can take the temporary approach we use on appropriations. Every subsidy that is involved in an appropriation process is looked at every year. When you build a subsidy into the tax law, sometimes it is never looked at again, it is in year after year after year. These are examples of what I mean by a temporary approach to a complex situation.

Mr. Stanton, if I were completely sure myself as to what the right answer was at this juncture, I would say go ahead and do something permanent. But experience has indicated to me, after 5 years in the U.S. Treasury, that my wisdom is not that great. I am not confident of our wisdom in the administration, of working out a solution that will last for years and years. It has been my experience that the best thing to do is to do the best you can at the time, but then call it up and look at it again in a year or 2 years.

Mr. STANTON. One last question, Mr. Barr.

Mr. Randall appeared before the committee, and he referred to the fact that the FDIC and the Federal Reserve Board have undertaken a study to trace as best they can these CD's, and that this report should be available in 2 or 3 weeks' time and basically it is his thought that the committee not do anything at the present time until the study becomes available. Would you generally follow along that line of thinking?

Mr. BARR. Statistics are a bit vague in this area. But on the other hand, I think the committee has enough information to act at this time if they want to act. I don't think that the statistical studies are going to show that much. I don't know if they will show flows between banks and other institutions. I think the central fact is established.

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Mr. STANTON. We know that money came out of the S. & L.'s. Will it show where it went?

Mr. BARR. Their study will not show where that money went.

Mr. STANTON. Did it go to the withholding tax? I got a notice yesterday of paying $300 more for withholding. A year ago that money might have gone into an S. & L. Those are the types of things I hope the report will show.

Mr. BARR. This study will not show that, sir. There is only one way to trace that, and that is to ask each person who takes the money out of an S. & L. what they do with it, and this study they have underway is not designed to show that at all. It will show merely what the banks are paying in different parts of the country. It is interesting and helpful information, but I do not think it is crucial to the deliberation of this committee.

Mr. STANTON. Thank you. My time is up.

The CHAIRMAN. Mr. Gonzalez?

Mr. GONZALEZ. Mr. Barr, as a member of the FDIC Board, did you become familiar with the case of the Marlin Bank in Texas?

Mr. BARR. Yes, indeed.

Mr. GONZALEZ. And I believe the Colorado Bank, and the San Francisco Bank. Is it not true that at the bottom of those three defunct banks there was a misuse of these CD's?

Mr. BARR. Yes, that is true, Mr. Gonzalez. But I think it was way at the bottom, because I think at the top was crookedness.

Mr. GONZALEZ. I recall that you came before us, and we, on your recommendation, enacted legislation with respect to one aspect of it—that is the management aspect.

Mr. BARR. Yes.

Mr. GONZALEZ. It always seemed to me then, as it does now, that we still left this other area—the speculative use of CD's—pretty much open.

I am asking for a judgment opinion here. About how much of that kind of jiggery-pokery do you think is still going on?

Mr. BARR. I don't know Mr. Gonzalez, but I would say if the committee decides on a rate, say a 5-percent rate, or a 4½ rate—and a cutoff in this area—that you had better give enforcement power to these regulatory agencies, so they can enforce the rate, and stop these money brokers who are engaged in—some of them I saw were just on the verge of the underworld in these particular areas.

Now, there are very reputable money brokers. But many of these seem to be operating on the very fringe of the law, with associations with the underworld in one connection or another.

I would strongly recommend, Mr. Gonzalez, that if the committee determines to follow this approach, of establishing some rate limitation and cutoff, that you give the regulatory agencies the power to enforce it, and the power to stop these money broker vultures who might be moving in in this area. That will stop the jiggery-pokery, as you mentioned, or help to stop it.

Mr. GONZALEZ. One of the main reasons for my interest in this approach over legislation—I just wondered if in the meanwhile we have not waited too long, if possibly the biggest damage has not already been done. This thing has degenerated into a sort of battle of appetites between S. & L.'s and banks and so forth. But I think it is more

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fundamental than that. I think that the excessive, speculative opportunities based on CD practices are the things that we really ought to go after. And you believe that this suggestion of yours would have a dampening effect on this speculation?

Mr. BARR. I do, indeed—coupled with the authority to enforce it.

Mr. GONZALEZ. Thank you very much.

The CHAIRMAN. Mr. Minish?

Mr. MINISH. Thank you, Mr. Chairman.

Mr. Secretary, are you familiar with the Secretary's Coordinating Committee on Banking Supervision?

Mr. BARR. Yes, sir; Mr. Minish.

Mr. MINISH. How effective is it?

Mr. BARR. It is effective, but there is this structural defect, Mr. Minish. The chairman has called this to my attention on occasion. In effect, the Secretary of the Treasury is dealing with equals—because these people are not responsible to him, and they are not responsible to the President. They represent different segments of the financial community, with their own special interests. And under these conditions, Mr. Minish, I think there is a limitation on what can be accomplished.

Mr. MINISH. I would agree with that, because Chairman Horne said he was not consulted in advance when the rate was increased last December. Comptroller Saxon said he read about it in the Monday morning newspaper.

Do you really believe that coordination can be achieved informally among the three or four separate banking agencies without legislation?

Mr. BARR. I think Secretary Fowler has made a dramatic improvement in this area, Mr. Minish, within the limits, as I said, of the established structure.

They do meet. They do consult. They do thresh out these problems. But in the final analysis—we don't have the club that you have in the administration of a President saying—you are going to do it, you are in my administration, and this is the way we are going to run it. We cannot do that, because the only authority—the club is down here with you gentlemen.

Mr. MINISH. Chairman Patman's bill, H.R. 6885, will give you the club. Are you for it?

Mr. BARR. I am not acquainted with that bill, sir.

Mr. MINISH. It would consolidate Federal bank supervision in the Treasury Department.

Mr. BARR. I could say, Mr. Minish, this has great intellectual appeal. But somebody is going to have to give us two or three more Under Secretaries and Assistant Secretaries—because frankly, it is just a bit like handing us a pet rattlesnake. But I must admit it has intellectual appeal.

Mr. MINISH. Thank you. That is all.

The CHAIRMAN. Mr. Mize?

Mr. MIZE. Mr. Chairman—I don't believe that we should blame the tight money situation on the Federal Reserve entirely. I think the tight money market and the high interest rates are due to too many people trying to buy too much, too fast, including the Federal Government, and the Federal Government being the biggest borrower, buyer, and lender in the whole free world—perhaps if it would slow down a little bit in its activities, everything would ease up a little bit.

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I think we all agree that what the Federal Reserve did in December did more harm than good. Apparently they didn't realize some of the ramifications of what they did in December in advance.

I would like to explore what Mr. Stephens suggested. What about the resolution to admonish the Fed to reverse what they did in December? Did you say——

Mr. BARR. No, sir; I would not be for that. I do not agree, Mr. Mize. We did not agree with the timing of the Federal Reserve Board's action. But faced with the enormous demand, as you put it, that is confronting this economy today, we did not disagree with the action they took. We disagreed with the timing. We have been over this ground many times—we felt that the move toward a tighter credit posture in the United States should have been made in conjunction with a tight budget and tax action—so that the three would be mutually reinforced. We do not object to the direction in which they moved.

As you point out—I am not condemning the Federal Reserve Board for what they did at that time. I think they moved in the right direction. We have never objected to that. The President has this magnificent demonstration of pouring water in a glass. You can keep pouring water in that glass, and we can keep pouring money into the economy—up to a point. As the water rises in the glass, it will produce more production, more salaries, more wages, more taxable goods. But after you hit the top of the glass, it just spills over, and all you get is increased prices—you don't have anything else—no more labor, because there is no more labor, no more plant—we are just at the end of the rope. And all you get then is not more production, but just higher prices, which is counterproductive.

Mr. MIZE. Mr. Chairman, over the weekend I checked with the banks out in my congressional district. Kansas conservatives that they are, and even the largest banks in Topeka, down to the very smallest ones, are not paying over 4½ percent on their CD's. So I want you to know we are not creating the problems with the S. & L.'s out in Kansas. That is all.

Mr. BARR. If I could speak for Indiana, I think pretty much the same position pertains to Indiana.

The CHAIRMAN. Which section of the country did not heed the advice of those who warned them about paying more than 4½ percent?

Mr. BARR. I think——

The CHAIRMAN. In volume or money.

Mr. BARR (continuing). It has been the large money market centers—New York——

The CHAIRMAN. New York?

Mr. BARR (continuing). New York, California, several others.

The CHAIRMAN. Mr. Weltner?

Mr. WELTNER. Thank you, Mr. Chairman.

Mr. Barr, you would agree, would you not, sir, that it is really not an appropriate function of Congress to sit here and divide markets, territories, and competitive opportunities, among varying financial institutions?

Mr. BARR. No, sir; I don't agree with that, Mr. Weltner. You have that responsibility, and it has been done. It has been done for 30 years.

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Mr. WELTNER. You think that the Congress has the duty——

Mr. BARR. It doesn't have the duty. It certainly has the right, if it wants to exercise it. You have carved out responsibilities in rural electrification. You have carved it out in farming. It has been going on since 1917. You certainly have the right.

Mr. WELTNER. Well, philosophically, do you think that is a helpful and beneficial legislative act, to say who is going to get this market, and who is going to be prohibited by restrictions from competing in market?

Mr. BARR. You are on a philosophical gambit, Mr. Weltner—I don't know where it leads me precisely. But suffice to say that the Congress started in 1917 with the Federal Land Bank, and carved out a particular area of credit for farms. It kept on moving through the twenties, and carved out other areas. In the thirties it carved out an area of preference for homebuilders and thrift institutions. It has done it. There is nothing new or different about it.

Mr. WELTNER. Don't you think, then, we would be serving the national interest more fully if we insured that institutions were able to compete and to present their appeals to consumers on the basis of service?

Mr. BARR. I quite agree.

Mr. WELTNER. And don't you think when we take actions restraining interest rates to one group of institutions, that effectively precludes them from any share of a market—we are doing a disservice to the national interest?

Mr. BARR. Yes, indeed, sir.

Mr. WELTNER. So would it not be, then, the duty of the Congress in the face of this situation, rather than to try to divide up markets, to assure a competitive equality, or a parity of opportunity among financial institutions?

Mr. BARR. That would be my approach, Mr. Weltner.

Mr. WELTNER. Now, then, if we put a limit of $10,000 or $100,000 on the denomination of certificates of deposit, we are in effect excluding small investors from the opportunity to obtain a higher return on their money, are we not?

Mr. BARR. Perhaps. You can look at it that way. When I read my prepared statement, I pointed out that risk still exists in this country, Mr. Weltner.

Mr. WELTNER. But the risk is minimal—in view of the remarkable success of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation—the risk is something people talk about. It is not really there. And you agree the consumer doesn't consider himself——

Mr. BARR. Perhaps I am prejudiced. I closed 12 banks as Chairman of the FDIC, Mr. Weltner. And the memory of those failures still lingers on.

Mr. WELTNER. Well, under your enlightened leadership of the FDIC, Mr. Barr, you would have to agree that the risk is quite small?

Mr. BARR. Yes, it is.

Mr. WELTNER. And it is not the difference between 4½ percent and 5½ percent, is it?

Mr. BARR. Well, we are currently paying 4.15 percent on savings bonds, and selling a lot of them. This is an individual judgment.

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This is probably the best financial instrument in the world. And the fact that we can sell them in a free market at 4.15 percent does incline me to the view, Mr. Weltner, that risk is something to be considered.

Mr. WELTNER. Well, don't you think we would probably be a lot better off, rather than trying to find or discern the cut-off point between $10,000 or $15,000, or $100,000, simply to say that there shall be a parity in maximum interest rates that can be paid by financial institutions?

Mr. BARR. That is an approach, and it certainly has merit. I come back to the point, though Mr. Weltner, that a more realistic approach is to recognize the fact that there are really, I believe, two financial markets in the United States. One is a domestic, local savings market. The other is the market that is represented by the chart you have back here, that represents national savings of corporations that flow——

Mr. WELTNER. Those are negotiated CD's, though. They don't advertise that at 5 percent.

Mr. BARR. That is correct.

Mr. WELTNER. You go into the market, you place your money, and you have spreads of small fractions of a percent.

Mr. BARR. That is correct.

Mr. WELTNER. Well, suppose we had a provision that said on any nonnegotiated CD—I don't know how you define that—but on any consumer type CD, where there is an advertised interest rate, that there shall be a maximum of, say, 5 percent payable. Forget about increasing reserves, forget about maturities, forget about the denominations themselves—and say that on consumer CD's there should be a maximum of 5 percent. Now, with the action of the Federal Home Loan Bank Board, effective July 1, there are savings certificates that will be able to compete with the S. & L.'s at 5 percent. Then the corporate controllers who are looking around and negotiating for interest will not be affected by that. And we would not be drawing a line in the Congress wherein the small investor is restricted to 4½ percent, and we would avoid the situation where banks may very well go to 5½ percent under regulation Q upon the effective date S. & L.'s to go to 5 percent themselves. We will take them off the escalator. Do you think that is wise?

Mr. BARR. Yes, sir. I think we are all moving in the same direction, Mr. Weltner. It is a question of how you define that consumer CD. One definition, of course, would be some place in the range of from $10,000 to $100,000.

Mr. WELTNER. Why don't we just put it on the way in which the bargain is made. Aren't these things bid and asked in a money market?

Mr. BARR. The negotiable CD's, that is right.

Mr. WELTNER. If you put it on that basis, then the market would define it in and of itself?

Mr. BARR. The negotiability, as I understand it, is worked out with the banks. There may be a possibility of this approach.

Mr. WELTNER. I am not talking about the negotiable aspect of the instrument itself, but the fact that the return on the money to be deposited is negotiated.

Mr. BARR. Oh. You object to establishing a figure, say either $10,000 or $100,000—you want to confine this rate limitation to the consumer CD, as I understand it. Is that correct?

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Mr. WELTNER. A maximum limitation of 5 percent on consumer CD's, those being defined as those CD's issued without the negotiating process in the great money markets in the East, but issues by the bank around the corner.

Mr. BARR. The hundred thousand dollar cutoff would accomplish approximately the same purpose.

Mr. WELTNER. Now, if that were the case, that could be accomplished by directing the Federal Reserve to revise regulation Q accordingly?

Mr. BARR. No; you would have to give them legislation. They do not have that authority currently, Mr. Weltner.

Mr. WELTNER. They have authority to base interest rates upon conditions of repayment, haven't they?

Mr. BARR. Yes. But it is my understanding that they do not have the authority to specify a different rate based on the amount of a deposit and that they do not currently possess the authority granted by the Congress to make a differential between these two types of deposits.

Mr. WELTNER. If we gave them the authority and expressed the sense of Congress that the authority should be exercised, and a 5 percent rate should apply, and somehow we made a strong intimation that 5 percent should also be authorized by the Federal Home Loan Bank Board wherever it may not be now authorized, that might very well solve this problem.

Mr. BARR. Yes, sir.

Mr. HALPERN. Would the gentleman yield?

Mr. WELTNER. My time has expired.

Mr. HALPERN. Are you talking about a 5-percent limit on bank deposits—saving and loan shares, and saving bank deposits?

Mr. WELTNER. I am ruminating over the possibility of a 5-percent maximum on consumer certificates of deposit issued by commercial banks, and a 5-percent maximum interest return on what is called savings certificates issued by savings and loan associations.

Mr. HALPERN. Thank you.

Mr. WELTNER. My time has expired, Mr. Chairman.

The CHAIRMAN. Mr. Gettys?

Mr. GETTYS. Mr. Chairman—first let me say at the instance of and in behalf of our colleague on the committee, Congressman Hanna of California, who is necessarily absent, I would like to ask unanimous consent that a telegram to him from the chairman of the board of the Bank of America be inserted in the record at this point.

The CHAIRMAN. Without objection, so ordered.

(The telegram referred to follows:)

LOS ANGELES, CALIF., *June 3, 1966.*

Hon. RICHARD HANNA,
Anaheim, Calif.:

We understand House Banking and Currency Committee will shortly go into executive session to consider legislation affecting the issuance of certificates of deposit in banks. Some of the proposals have such far-reaching implications to the entire economy that hasty or ill-considered action could do substantial damage. We would respectfully ask that you give consideration to these observations:

(1) Limitation of maturity and holding period.

There are essentially two types of certificates currently issued. Larger denomination CD's are issued to major business firms and are considered to possess substantial secondary market liquidity. This liquidity should be encouraged and no minimum holding period should be imposed after issuance.

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Regulation Q authority to issue large CD's for 30 days or longer should continue. Large denomination CD's have been used effectively by business firms as a prime liquidity vehicle and this type of financial holding should be encouraged as an important money market instrument.

Small denomination certificates are also issued for appeal to small savers. Generally speaking, the minimum maturity is limited to 6 months or more. Since these represent more stable savings balances a 6 month limitation could possibly be employed as long as the same requirement is imposed on the certificates issued by all types of thrift institutions.

Emergency prepayment of all types of certificates should continue to be permitted upon proper written notice.

(2) Limitation of minimum denominations of certificates.

There is no valid reason for limiting the minimum denominations of certificates unless the same rules are established for all types of thrift institutions. Generally speaking, the banks have established relatively large minimum denominations on negotiable CD's to improve their secondary marketability. With regard to thrift certificates smaller denominations are made available to fit the requirements of individual savers. This flexibility should continue to be made available at the discretion of the institution unless a uniform rule is established in the thrift area.

(3) Limitation on interest rates paid on certificates.

Within the framework of regulation Q member banks should continue to have full discretion as to interest rates offered on all certificates. A competitive market rate structure is a vital key to a continued healthy financial mechanism. On many occasions in the postwar period member banks have been put at a serious competitive disadvantage by unrealistic rate limitations imposed under regulation P. All financial institutions should be permitted to set rates as they see fit within a regulatory environment that is consistent and equitable for all.

(4) Increased reserve requirements for bank certificates of deposit.

Present reserve and liquidity requirements for various types of financial institutions differ and produce an inequitable competitive environment. There have been long standing proposals to reduce or eliminate reserve requirements on savings and time deposits of commercial banks or revise the requirements to make them consistent with those applying to other types of institutions. Any proposed changes to increase reserve and liquidity requirements should receive careful and thorough study before implementation to insure their equity and effectiveness among financial institutions and to assess carefully their economic impact. The concept of liquidity should carry the same quality and quantitative characteristics for all financial institutions. In particular, there is no economic justification for discriminatory treatment of banks according to size or volume of activity. There is a danger in this kind of approach in the regulation of any industry. Regulatory bodies should not penalize efficiency by imposing discriminatory reserve requirement which generate pressures for additional earning power where competition is most intense. Indeed, size offers stability and improved safety characteristics which reduce the need for required reserves.

In summary, it is clear that an inequitable and unrealistic regulatory environment for various types of financial institutions has caused problems in the postwar period. Preferential tax and regulatory treatment of savings and loans encouraged their rapid growth at the expense of other types of institutions during much of the period. In turn, this resulted in problems for other major competitors more recently, a greater degree of equity has been brought into the regulations, and S. & L.'s have encountered problems in sustaining their former growth rate, although they still enjoy preferential tax benefits. These problems cannot be attributed to unfair competition from banks or other money market competitors such as Federal agencies. The problem lies in the inability to continue an artificial growth rate without regulatory suppression of fair competition. Fair competition is in the public interest. It is wholly unreasonable and inequitable to impose new restrictions on commercial banks in an effort to help S. & L.'s with a problem for which the banks are not to blame. The pending proposals erroneously assume that, first, all funds not going into S. & L.'s are now going into the banks, and second, in consequence, the real estate loan market is suffering unduly. It is obvious that funds are going to many places other than banks. Moreover, banks make substantial real estate loans, as well as meeting other important credit demands.

Bank of America is currently using the limited flow of deposit funds to satisfy many essential credit demands. Emphasis is being placed on credits

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that serve the most productive needs and desirable economic growth in our serving area. This includes, but is not limited to, significant support to the housing and home construction industry, evidenced by a mortgage loan total now exceeding $3 billion.

The pending proposal erroneously assumes that first, all funds not going into S. & L.'s are now going into the banks and second, in consequence, the mortgage market is suffering unduly. It is obvious that funds are going to many places other than banks. Moreover, banks make real estate loans as well as meeting other credit demands. Bank of America is currently using the limited flow of deposit funds to satisfy many essential credit demands. Emphasis is being placed on credit that serves the most productive needs and desirable economic growth in our serving area. This includes, but it is not limited to, significant support to the housing and home construction industry, evidenced by a mortgage loan total now exceeding $3 billion dollars.

Revision of regulations applying to financial institutions is a serious matter. The problem should not be approached on an emergency or piecemeal basis. In an effort to solve the S. & L. problem real damage could be done to normal bank deposit relationships and to the broader flow of savings to all types of financial institutions upon which the entire economy is based. If revisions are required they should come as the result of careful study and should always keep in the forefront the public welfare and freedom of choice through maintenance of an equitable competitive environment. To do otherwise would only compound the overall problem and would be highly discriminatory.

LOUIS B. LUNDBORG.
Chairman of the Board, Bank of America N.T. & S.A.

Mr. GETTYS. Mr. Secretary, the savings and loan association industry, I believe you referred to, was created in the 1930's for a special purpose.

Mr. BARR. It existed, Mr. Gettys—called building and loans. But it was formalized by Federal entry into the system.

Mr. GETTYS. And the special purposes are thrift and homebuilding.

Mr. BARR. That is correct.

Mr. GETTYS. Now, hasn't it been true that the policy of the country has been that they should not necessarily compete on an equal basis for funds to use in the implementation of their special purposes?

Mr. BARR. The policy of the country, up until quite recently, has been that they had a preferred position on rates and on taxes.

At least that has been the way it has evolved. I have not seen it written in stone any place. But that has been the fact.

Mr. GETTYS. That has been the fact.

Mr. BARR. And it has never been reversed.

Mr. GETTYS. Now, has the present situation reversed the policy or the fact as the case may be?

Mr. BARR. In my opinion, it has.

Mr. GETTYS. Now, shouldn't—should the savings and loan industry in your opinion compete on an equal basis with other financial institutions for the money that is available?

Mr. BARR. That would be my recommendation, that we move towards equality of competition in this area.

Mr. GETTYS. All right. Now, would you eliminate the special purposes of the savings and loan industry? That is, would you have the commercial banks and the savings and loans compete for the mortgage money market, not only from the standpoint of funds, but from the standpoint of purposes for their existence?

Mr. BARR. Your point is well taken. I think that Governor Robertson has indicated that eventually pressures on the country might eventually cause the evolution of one type of financial institution—as the savings and loans attempt to broaden their lending powers and the

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banks attempt to move into what were traditionally S. & L. functions of homebuilding. You in essence would have all these forces coming together. However, I think that is quite a way down the line.

The essence of our recommendation before you today is that in competition for savings they be equated. Perhaps you would want to examine the matter of broader lending authorities later—and in that connection take a look at their tax picture.

Mr. GETTYS. Wouldn't that do—if your recommendation is effective, would not the competition for savings automatically take care of the purposes of the institution? I mean wouldn't it bring about the business of competition in home loans, competition in appliances, automobiles, and that sort of thing?

Mr. BARR. They don't have the authority at the moment.

Mr. GETTYS. I say as an end result.

Mr. BARR. I would think the tendency would be in that direction.

Mr. GETTYS. And should the Congress now, as a matter of legislative policy, aim toward that eventuality?

Mr. BARR. Mr. Gettys, I would like to reserve judgment on that, if I may. We are looking at an immediate problem.

Mr. GETTYS. I think this question has something to do, though, with the present situation.

Mr. BARR. I quite agree.

Mr. GETTYS. If we are to take action now to make the competition for savings equitable, then are we establishing something new in history——

Mr. BARR. That is correct. I would agree. You are moving in this direction. This is another reason, Mr. Gettys, that I would think this legislation should be temporary—because we are moving in the direction that you have indicated. Perhaps in a year or 2 years you would want to look at the whole situation again, and at that time maybe we could all have a better focus as to whether or not these powers should be broadened.

Mr. GETTYS. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Fino?

Mr. FINO. Thank you, Mr. Chairman.

Mr. Secretary, if we place, as you suggest on page 4 of your testimony, a high ceiling of $25,000 to $100,000 on CD's, wouldn't we once again be taking care of the fat cats to the detriment of the little patriotic wage earner who has to content himself with a 4.15 percent interest rate on the Government savings bonds?

Mr. BARR. Well, he has an alternative.

Mr. FINO. When I make reference to the fat cats—that is the reference I had to the Participation Sales Act.

Mr. BARR. Would you repeat the question, Mr. Fino. I thought I was on CD's. We seem to have slipped over——

Mr. FINO. If we place this limitation of $25,000 to $100,000 on the CD's, wouldn't we be taking care of the fat cats to the detriment of the little guy who is buying these savings bonds at 4.15 percent?

Mr. BARR. As I understand the proposal, Mr. Fino, it would limit the amount of interest paid on deposits under $100,000 to 5 percent. This in essence is our proposal. So the little fellow, as you mentioned, could either buy our savings bonds——

Mr. FINO. At 4.15 percent.

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Mr. BARR (continuing). At 4.15 percent, and he is doing it willingly today in the free market, or he could, if he wanted to, put his money in these savings deposits or in CD's at the 5 percent rate that we have indicated we think is appropriate. And that would go all the way up to $100,000. I don't think there are many little guys, that I know of at least, with $100,000 in liquid assets.

Mr. MIZE. Would the gentleman yield just a second?

Mr. FINO. Yes, I would be very happy to yield.

Mr. MIZE. Mr. Fino, why doesn't the little guy be patient a few weeks and buy some of these participation certificates that are going to be 5¾ percent?

Mr. FINO. Except that the participation certificates are limited to those with $5,000 or $10,000.

Now, is it your suggestion on the CD's that we have up to $100,000—a ceiling up to $100,000 with a rate of 5 percent?

Mr. BARR. That is the direction we have indicated.

Our proposal has been that it be $10,000 and 5 percent. I have been reminded of the fact that this poses political difficulties, so we have said there is no objection to going as high as $100,000. But we strongly recommend that the rate, if the committee decides to recommend a rate, be not lower than 5 percent at this time.

Mr. FINO. Then above $100,000, what rate yould you allow?

Mr. BARR. That would be up to the Federal Reserve Board. Currently is is 5½ percent.

Mr. FINO. Thank you.

The CHAIRMAN. Mr. Todd.

Mr. TODD. Thank you, Mr. Chairman.

Mr. Barr, I am always pleased to have you here because I think your answers are generally helpful, which is more than I can say for some of our witnesses.

You brought up the question of balance of payments this morning. Mr. Chairman, I would ask permission that a paper written by one of my constituents, Professor Ross of Western Michigan University, be made a part of the record at this point.

The CHAIRMAN. Without objection.

(The article referred to follows:)

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"OPERATION TWIST": A MISTAKEN POLICY?

(Myron H. Ross,* Western Michigan University)

During the past few years the Federal Reserve authorities, the Council of Economic Advisors (1965, pp. 68–69), and many academic economists have supported "operation twist." It is held that higher short-term interest rates stem the outflow of gold by inducing a flow of short-term balances to the United States and that lower long-term interest rates stimulate investment, moving the economy closer to full employment. Whether or not the objectives of balance of payments equilibrium and full employment are made compatible by means of operation twist is an empirical question. I shall argue that the empirical assumptions justifying operation twist are weak at best and may, in fact, involve positive error.

Let us initially assume that a given "twist" (that is, a sale of $1 billion in short-term securities and a purchase of $1 billion in long-term securities by the Federal

*I wish to thank my colleague Raymond Zelder for some astute comments and criticism.

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Reserve) has an equal and opposite effect on interest rates, raising short-term interest rates by the same percentage that long-term interest rates are reduced. In this case proponents of operation twist argue that aggregate investment will increase, with short-term investment (inventory) being restricted by a smaller amount by higher short-term interest rates than long-term investment (fixed assets) is stimulated by lower long-term rates.[1]

While there is uncertainty about its magnitude, empirical estimates of the long-term elasticity of investment tend to range between −0.3 and −0.5. Ando, Brown, Kareken, and Solow (1963, p. 36) conclude that the elasticity of fixed asset investment is between −0.3 and −0.4. Jorgenson (1963) estimated the elasticity of plant and equipment to be −0.4. Hammer (1964, p. 112) concluded that the short-run elasticity of fixed investment was −0.3 and the long-run elasticity −0.5. Grunfeld (1960, p. 240) estimated the elasticity of fixed-asset investment to be −0.5. Kuh and Meyer (1963, pp. 381–82) found a relatively low elasticity of −0.16 for manufacturing investment. Anderson (1964) found interest elasticities of demand for producer durables to be −0.39 and for farm equipment to be −0.67.

There is also a range of uncertainty with regard to the relationship between inventory spending and the interest rate. Ando *et al.* (1963, p. 44) conclude that the elasticity of the desired *stock* of inventory (not investment in inventory) is about −0.4. Past studies of the sensitivity of inventory stocks or inventory investment have been misleading for a variety of reasons. For example, Gehrels and Wiggins (1957) conclude that "there is no evidence of interest influencing the level of stock (of inventory)." But this conclusion is based upon data prior to the mid-1950's and does *not* reflect a significant institutional change which has taken place over the last decade or so, namely, the scientific management of inventory. As education in managerial economics becomes more widespread, more firms will apply scientific techniques, so that one may expect the interest-rate elasticity of inventory stock to approach −0.5.[2]

There are other reasons why inventory holding might be sensitive to interest rates. First, inventories are more divisible than fixed assets, thereby permitting marginal adjustments to changes in interest rates; in contrast, fixed-asset investment often takes on an all-or-none character. Second, the risk element is theoretically less significant for inventory spending than for long-term investment, so that one would expect interest-rate considerations to be mode significant for the former.

Methodological problems seriously limit the value of existing statistical studies, which generally do not reflect recent developments in the scientific management of inventories—the notable exception being the Ando *et al.* study (1963). It is important to make a distinction between *desired* and *realized* inventory spending. If there is a negative relationship between *desired* inventory spending and interest rates, there is no necessary reason to believe that there will be a negative relationship between *realized* inventory spending and interest rates. If interest rates are reduced and there is a negative relationship desired inventory stocks and interest rates, firms will try to increase inventories; but because income and consumption grow as a consequence, it is very possible that the increase in spending for additional inventory stocks by firms is smaller than the decrease in inventory stocks resulting from additional consumer spending, so that the *net* effect is to reduce realized inventories. Thus we can observe a positive statistical relationship between *realized* inventories and inerest rates,

[1] This seems clearly implied by the following statement in the *Economic Report of the President for 1965* (Council of Economic Advisors, 1965, pp. 66–67): "Although U.S. short-term interest rates have been nudged upward to prevent an outflow of interest-sensitive funds seeking higher rewards abroad, policy has endeavored to avoid transmission of these pressures to the long-term market (*more crucial for domestic investment*) and to maintain a ready availability of credit relative to demand." (Italics mine.)

[2] This value would tend to be approached under conditions of certainty, where the least-cost inventory to be ordered is given by:

$$Q=\sqrt{\frac{2Sp}{i}},$$

where Q is the optimum quantity to order, S is sales, p is the procurement cost per order, and i is the interest rate or carrying costs of inventory. If demand is constant during the period between orders, then the average inventory on hand is $Q/2$. The elasticity of Q with regard to i is −0.5 (see Whitin, 1952). Under conditions of uncertainty a safety allowance is necessary. The effect of the safety allowance on elasticity depends on the model of uncertainty one employs. If safety allowances are related to interest rates, the difference between elasticities with certainty and with uncertainty are probably small (see Arrow, Scarf, and Karlin, 1958).

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which does *not* reflect the negative relationship between *desired* inventories and the interest rate.

Terleckyj's (1961) study, which concluded that interest rates were insignificant for inventory investment, did not make the distinction between desired and realized inventory because he permitted the interest rate to affect inventory only over one quarter. Ando *et al.* (1963), in contrast, allowed for unintended inventory changes by permitting inventory stocks to be influenced by interest rates over a longer period.[3] It appears there are sufficient empirical and theoretical reasons for concluding that the elasticity of desired inventory stock is in the neighborhood of −0.3 to −0.5.

What is the impact of the twist on aggregate investment? To allow for uncertainty regarding the magnitudes of the elasticities, six cases with varying elasticities are shown in Table 1. It should be noted that the inventory elasticity has a greater impact than the fixed-investment elasticity on aggregate spending because the stock of inventory ($108 billion at the end of 1964) exceeds the amount of fixed investment ($84 billion over 1964). In cases 1, 2, and 3 operation twist would be mistaken, since aggregate investment would be reduced significantly. In case 1 operation twist would be mistaken because (assuming a multiplier of about 2) GNP would fall by about $6 billion. In cases 4 and 5 operation twist would be more or less neutral, since the impact on investment is negligible. Only in case 6 could operation twist make some claim to justification. Since the lags between interest-rate changes and spending with regard to inventory stocks and fixed asset investment are of the same order (Ando *et al.*, 1963, pp. 29, 44)—roughly two years—our conclusions based on Table 1 refer to a period of about two years.

In the above discussion we have assumed a symmetrical twist with short-term interest rates rising by the same percentage as long-term interest rates fall. It may be that with a given twist the results are asymmetrical. For example, a simultaneous purchase of long-term securities and sale of an equal amount of short-term securities by the Federal Reserve may raise short-term rates proportionately less than long-term rates fall.[4] However, if short-term elasticities of spending with regard to short-term rates are significantly greater than long-term elasticities with regard to long-term rates, then investment spending may diminish even though the relative rise in short-term rates is less than the fall in long-term rates. On such a basis operation twist would still be considered mistaken. If the spending elasticities were reversed, so that total spending increased, operation twist would be justified. On the other hand, it may be that the proportionate rise in short-term rates *exceeds* the fall in long-term rates. If so, the decline in total spending would be accentuated if the short-term elasticity with regard to short-term rates were significantly greater than long-term elasticity with regard to long-term rates, so that the likelihood of operation twist being mistaken would be increased.

What is the capacity of the monetary authority to twist the structure of interest rates? There have been several studies whose results have varied. Okun (1963, p. 361) contends that the rate structure cannot be significantly changed. He found that a $1 billion purchase of long-term securities and a $1 billion sale of short-term securities will have a *direct* effect (short-term open-market operations impact on short-term yields; long-term open-market operations impact on long-term yields) of raising short-term rates by between 0.19 and 0.41 percentage points, while long-term rates will fall by between 0.07 and 0.09 percentage points. The direct effect implies that if this were the only effect, a $1 billion twist would probably diminish total spending if the elasticities of Table 1 are correct. However, if we take *indirect* effects (short-term open-market operations impact on long-term yields; long-term open-market operations impact on short-term yields) into account, we are forced to conclude that the Federal Reserve has little power to affect the interest-rate structure. Short-term sales of $1 billion by the

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[3] Lovell (1961, p. 134) found a positive relationship between inventories and interest rates and suggests another possible reason for this relation: "Changes in sales and possibly orders as well lead to an expansion in the level of inventories that firms want to carry at the current rate of interest. This causes the demand schedule for loanable funds to finance these holdings to shift to the right along a comparatively stable supply schedule for loanable funds. Although a positive association between interest rates and inventories results, this has little bearing on the issue of how sensitive inventory investment is to interest rate changes."

[4] One is tempted to say that "the average level of interest rates has fallen." However this raises the familiar index number problem of how to weight the different interest rates. This problem is particularly difficult when some interest rates are rising and some are falling.

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Federal Reserve will increase long-term yields by between 0.06–0.08 percentage points; long-term purchases of $1 billion decrease short-term yields by between 0.16 and 0.39 percentage points. Thus the combined direct and indirect effects leave the structure of rates unchanged. Okun (1963, p. 369) concludes: "*How much* the Federal Reserve buys (or sells) is far and away more important than *what* issue it chooses to deal in."

TABLE 1.—*Impact on aggregate domestic investment of simultaneous 10 per cent increase in short-term interest rates and a 10 per cent decrease in long-term interest rates*

Case	Elasticities		Change in investment (billions of dollars) [1]
	Inventory stock	Fixed-asset investment	
1	−0.5	−0.3	−$2.88
2	−.4	−.3	−1.80
3	−.4	−.4	−.96
4	−.4	−.5	−.12
5	−.3	−.4	+.12
6	−.3	−.5	+.96

[1] This is equal to the product of the inventory stock elasticity and the $108,000,000,000 stock of inventory in manufacturing and trade *plus* the product of the fixed-asset-investment elasticity and the $84,000,000,000 of fixed investment in 1964 (Council of Economic Advisors, 1965, pp. 202, 237).

However, Okun's conclusions have been questioned by Scott (1965), who shows that, with a more sensitive measurement of the maturity structure of the marketable federal debt, there is evidence that the interest-rate structure can be twisted. Scott says (p. 138): "Lengthening the debt by one month coincides with an increase in the long-short spread by 3.5 basis points." Moreover, he finds that the short-term interest rates show the larger adjustment in response to a given change in the maturity structure of the debt. If short-term rates rise more than long-term rates fall, aggregate investment will diminish more (or increase less) than the symmetrical twist result shown in Table 1.[5]

On the basis of the above discussion we may say that operation twist is more likely to be mistaken than justified, because with reasonable assumptions about the basic parameters involved, it inhibits domestic investment. But this conclusion would fail to take account of the positive good done in terms of increasing the inflow of short-term balances into the United States, which also must be considered.

If we use Stein's (1965) results, which indicate that foreign short-term balances are fairly sensitive to short-term interest rates, to estimate the magnitude of this effect we put operation twist into a potentially more favorable light than would appear from the use of previous studies by Gemmill (1961) and Bell (1962) on this question, which found relative insensitivity of capital flows to interest rates. Let us assume that a percentage-point increase of 1 in short-term rates (holding United Kingdom rates fixed) is roughly a 33 per cent increase in United States short-term rates, starting with a 3 per cent short-term interest rate in the United States. If this percentage change can be associated with a $462 million increase in annual short-term capital inflow (as Stein indicates), then one might expect an increased inflow of about one-third this amount, or $154 million, with a 10 per cent increase in United States short-term rates resulting from the twist. Thus, one may buy a very small improvement in the balance of payments with operation twist at a very high price.

In summary, operation twist appears likely on balance to have depressed economic activity, because its proponents have underestimated the magnitude and elasticity of inventory demand relative to demand for investment in fixed assets. In addition the twist is likely to be asymmetrical, with short-term interest rates rising more than long-term interest rates fall, reinforcing this con-

[5] Malkiel (1964), utilizing a modified expectations approach to the rate structure, agrees that the structure of interest rates can be modified. His study indicates that the probability of changing the interest-rate structure is greater than that indicated by Meiselman's (1962) study, because the latter assumes that a swap operation can only change the rate structure by affecting expectations, while Malkiel takes into account the influence of relative supplies of securities and institutional factors as well. Wood (1964) and Kessel (1965) also introduce other factors than expectations in explaining the rate structure.

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clusion. The policy-maker must make a judgment on whether the "success" of the policy is worth the "failure" of the policy; that is, is an additional inflow of only $154 million worth a diminution of possibly $6 billion in GNP? The answer depends on whether we have a viable alternative policy. Is it beyond the ingenuity of American policy-makers to find an alternative policy which increases foreign spending in the United States (or reduces American spending abroad) by a miniscule $154 million without diminishing domestic spending, GNP, and employment?

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Mr. TODD. Mr. Ross makes the point that our Operation Twist—high interest rates on short-term money—has enabled us to retain no more than $154 million—currencies which otherwise would have gone abroad. So the net impact on the balance of payments is $154 million.

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If his thesis is correct, the price we pay, by our high short-term interest rates, to maintain money in this country, is exorbitant. And I would like, for the record, for the Treasury to analyze this paper and indicate where it may be mistaken—because unless the paper is mistaken, I would see no justification in using balance-of-payments problems as a rationale for high interest rates on short-term money.

Mr. BARR. I would be delighted to.

(The following statement was submitted by the Treasury Department:)

Professor Ross has assembled a number of empirical estimates of the interest-rate elasticity of investment made by economists and econometricians. Most of the estimates that he cites for long-term investment range between —0.3 and —0.5. In the case of inventory investment, he assumes—largely on the basis of *a priori* reasoning—that the elasticity coefficient for desired inventory stock also falls in a range of —0.3 to —0.5. By pairing various estimates in these ranges and assuming a simultaneous 10 percent increase in short-term interest rates and a 10 percent decrease in long-term interest rates, Professor Ross arrives at a range of estimates of the change in total investment (fixed asset plus inventory) that would occur in a period of about two years. The resulting range of investment is very wide, extending from a decrease of about $3 billion to an increase of about $1 billion.

The next-to-last paragraph of Professor Ross's article recognizes the benefits to the balance of payments that may result from an increase in U. S. short-term interest rates relative to those abroad. An empirical study by Professor Jerome Stein is cited in support of the view that a 10 percent increase in U.S. short-term rates might induce a $154 million annual short-term capital inflow (*American Economic Review*, March 1965, pp. 64–65). Of course, short-term rates in the U. S. have risen much more than 10%, and on this basis a greater effect on short-term capital flows might be presumed. Simultaneous changes in foreign rates further the analysis.

Professor Ross's concluding query whether "an additional inflow of only $154 *million* [is] worth a diminution of possibly $6 *billion* in GNP" appears to be more a rhetorical question than a scholarly finding and probably should be interpreted as such. His own Table 1 contains two cases in which investment (and hence GNP) actually increase after a "twist." More generally, the range of possibilities presented by Professor Ross is so wide that there actually is little basis for a quantitative estimate of the GNP and balance of payments effects of higher short-term interest rates.

The limited scope of the Ross article apparently precluded any examination of the coordinated use of fiscal, monetary and other policies in the interest of achieving domestic and international goals. Yet, any satisfactory assessment of monetary and debt management policy during the current expansion would have to allow for the more active use that has been made of fiscal policy to encourage over-all expansion and a high rate of productive investment. This has allowed monetary policy to be more responsive to international considerations. It might also be pointed out that in a fully employed economy a degree of fiscal and monetary restraint is currently necessary both in view of domestic and international considerations.

Mr. TODD. We obviously have a complex problem before us. I have been trying to break it down into component parts. I wonder if you would agree that we have three interrelated problems before us.

One is a potentially severe liquidity problem. In some California savings and loan associations, due to an overexpansion and unsound policies, this problem is not correctable simply by allowing them to pay higher interest rates. This is a management problem, and not necessarily an interest problem with certain savings and loans. Is this valid?

Mr. BARR. Mr. Todd, I am not familiar with the situation in southern California. Mr. Horne has expressed himelf along these lines. If the situation is as you describe it, I would quite agree that this is a management problem.

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Mr. TODD. Then we have—the second problem—we have a less severe liquidity problem with other savings and loans, certainly in Midwestern States, where money is going from the savings and loans saver to the banks which are attracting CD money.

Then a third, we have a potential liquidity crisis with some of the large city banks as the result of CD maturities coming due at tax payment time. This was characteristic of December, and apparently is a potential problem now.

These are the three basic problems we are trying to come up with some solution for.

Now, let me offer possible solutions in reverse order.

One, for the liquidity problems of the banks, it would be feasible for the Fed simply to increase the money supply to handle the liquidity crisis when it comes due, would it not?

Mr. BARR. It could. But I would be most reluctant to see a faster increase in the money supply at this time. I think it could result in nothing but higher prices.

Mr. TODD. I would thoroughly agree. And yet, by and large——

Mr. BARR. A temporary increase.

Mr. TODD. There was an increasing money supply recently, at the greatest rate in history, and I wonder if there is not a reflection of the Fed's inability to take any other policy to alleviate the crisis?

Mr. BARR. I think it is a reflection of the enormous demand for money in this country. The demand for increases in productive capacity that are facing this country and being met is really incredible. And this is giving us the power to put out the goods and services to soak up demand.

Mr. TODD. Consequently, the Fed is really unable to maintain a tight money policy, because of the tremendous demand for money?

Mr. BARR. I would agree that the policy of the Federal Reserve Board so far this year could not be characterized as a tight money policy, that is correct.

Mr. TODD. And I think the St. Louis Federal Reserve Bank has characterized it as a policy without restraint.

My time has expired, so I won't go into the further questions I have. I might submit them for the record.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Ottinger.

Mr. OTTINGER. Thank you, Mr. Chairman.

You have recommended and a number of other witnesses have recommended, because we are sailing somewhat uncharted courses, that there be a degree of flexibility in any action that we take with respect to CD's. That is very appealing; however, we run into a problem that the Federal Reserve Board members in appearing before this committee said if they were given discretion in this area, including the ability to discriminate with respect to denominations, they would not use it.

Do you think it would be advisable for us to move in the direction that the chairman of this committee has been considering and repose the discretion to change these interest rates in the Secretary of the Treasury at this time instead of the Federal Reserve Board?

Mr. BARR. No, sir; I would not like to have that authority at this time. This would be a subject that I think this committee should

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debate seriously. It goes to the whole question of whether or not you want to keep the control of monetary policy isolated in an independent agency.

Congress has changed this since 1913, and I would not be prepared to recommend any such shift at this point.

The Federal Reserve Board has stated time and time again that they will respond to a directive from the Congress of the United States.

Mr. OTTINGER. But that requires us to freeze the situation.

Mr. BARR. No; it does not.

Mr. OTTINGER. It requires us to tell them to put the interest rate at 4½ or 5 percent.

Mr. BARR. You can indicate——

Mr. OTTINGER. When we leave it to their discretion, they say they won't exercise it.

Mr. BARR. Mr. Ottinger, you can give them the authority to make this differential, and you can specify that it is the intent of the Congress that they fix the rate at a given point, say some place in the area of around 5 percent. You can express the intent of Congress, and I know they will follow it. They have said so time and time again.

The CHAIRMAN. Will you yield to me just a minute. They are not conceding anything, Mr. Barr. They would have to do it anyway.

Mr. BARR. That is quite correct, Mr. Chairman. The authority is there. They would have to do it. I agree.

Mr. OTTINGER. But that would leave us without the degree of flexibility you have been talking about in the event there are unforeseen consequences of the action taken. They would not be able to adjust.

Mr. BARR. I think that you should give them the discretion to change. I do not think that you should lock them in, and the Congress should not be locked in in these flexible situations. Secretary Fowler has indicated it several times. But I believe that a strong expression of opinion by this committee will be acted upon and be respected by the Federal Reserve Board.

Mr. OTTINGER. A number of——

Mr. BARR. And that doesn't lock them in for all time.

Mr. OTTINGER. A number of witnesses before the committee, both in the Government agencies and outside, have suggested that perhaps the best way to help this tight money situation with respect to home mortgages is to increase the lending authority of the Home Loan Bank Board or the FNMA.

Wouldn't the Treasury oppose such a move on the basis this would be further expanding the credit available to the public, and therefore encouraging inflation?

Mr. BARR. We are not prepared to comment specifically on the FNMA issue at this time. And that would also apply to the issue of the Federal Home Loan Bank Board going into the market to borrow funds to pump back into the building industry to expand the activities of the building industry. As to whether you want to keep them level——

Mr. OTTINGER. Why are you not prepared to comment?

Mr. BARR. We are expressing a policy position in the statement that you have before you, Mr. Ottinger. The effect is that we think the building industry should have a relative degree of stability in this area.

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We are not saying it should be expended. But the whole thrust of my statement is to stop an outflow of funds from the savings and loan institutions so that the building industry, can maintain the course that they have underway a the moment.

Mr. OTTINGER. My time has expired.

The CHAIRMAN. Yes; and if you gentlemen will shorten your time a little bit, so all the members can question. We have Mr. McGrath, Mr. Halpern, and Mr. Reuss.

Mr. Halpern?

Mr. HALPERN. Mr. Secretary, we talk of thrift institutions. But isn't it a fact that banks have $92 billion of passbook savings compared with $52 billion in mutual savings banks and $110 billion in savings and loan associations? Now, is seems to me that we cannot ignore the very important position of banks as savings institutions. In other words, we have to be very careful in anything that we might do, that we don't create more problems than we solve. Do you agree with that?

Mr. BARR. That is correct. When I use the term "thrift institution", I probably was referring to the concept of a mutual thrift institution as distinct from a profitmaking institution, which I think of as a commercial bank.

Mr. HALPERN. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. Secretary, if CD's were not available for corporations to put their money into, where would you expect them to place their extra money?

Mr. BARR. Probably some of it in Treasury bills.

Mr. MCGRATH. That is all.

The CHAIRMAN. Which would run the rate down, would it not?

Mr. BARR. Yes, sir.

The CHAIRMAN. Wasn't that the reason that induced them to go to CD's at a higher rate than they could get in Government short term, so as to run the short-term rates up?

Mr. BARR. That was part of the reason. We cannot object, sir.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman. Secretary Barr, I want to ask you about the fourth proposition put to you in the Chairman's letter to Secretary Fowler of June 6. That has to do with making bonds of the Federal Home Loan Bank eligible for open market purchase by the Federal Reserve. I myself think this would be a good idea. The bonds are not now eligible. If they were, and the Fed in its wisdom saw fit to make such purchases, that would have the effect of making funds directly available to savings and loan associations which in turn would make them directly available to the homebuilding industry which we are told is now suffering from something like 9.9 percent unemployment rate and has excess capacity.

If, for example, the Fed bought Home Loan Bank securities, this would tend to lower the interest rate on those securities. To the extent that they obtained the open market funds for this purpose by selling or refraining from buying Treasury bills, this would have a good effect, because nowadays, as you well know, we are trying to

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put whatever interest-rate increases in the money instruments that may be necessary on the short side for balance-of-payment reasons.

I will now sign off, and ask you for your opinion of the proposal I have described.

Mr. BARR. Mr. Reuss, the Federal Reserve Board currently has the authority to invest through their open market operations in obligations of the Farmers Home Administration, the Federal Housing Administration, Commodity Credit Corporation, Federal Farm Mortgage Corporation, and District of Columbia Armory obligations.

I think the Congress would be completely consistent if they would add the securities of the Home Loan Bank Board to this list. It would, if exercised in the way you indicated, have the result of driving down the rate on the Home Loan Bank issues.

Mr. REUSS. As you know, I have been very concerned about getting the maximum amount of coordination of our monetary policy we can in this country. And if Congress did make a purchase of Federal Home Loan Bank securities eligible for the Fed, I would envisage an orderly way of working things to have, say, the Secretary of Housing and Urban Development and the Secretary of the Treasury from time to time notify the Fed of any deficiencies in the homebuilding industry, and then of course the Fed, in its independent judgment, would do anything it wished, but at least it would have the recommendation of the Secretary of the Treasury, who is responsible for our money, and the Secretary of HUD, who is responsible for our housing. Does that seem to you an orderly way to run things?

Mr. BARR. Speaking just off the cuff, it seems to have an orderly flavor. I would hesitate to commit my colleagues, either Secretary Weaver or Secretary Fowler. I would like to supply an answer for the record, if I could, Mr. Reuss.

Mr. REUSS. If you would. But I am pleased to hear your reaction.

(The following statement was furnished by the Treasury Department:)

The Treasury would have no objection to giving the Federal Reserve Banks the authority to purchase Federal Home Loan Bank obligations. Such authority might improve the marketability of Federal Home Loan Bank obligations and increase the scope of the Federal Reserve Open Market Operations. However, the Treasury would have serious reservations about the use of such open market operations as a major vehicle for channeling funds into the mortgage market. In addition, the Treasury would not favor an arrangement whereby the Secretary of the Treasury and the Secretary of Housing and Urban Development were formally recommending to the Federal Reserve how to conduct its open market operations and in which direction to channel financial resources.

The CHAIRMAN. Mr. Barr, I didn't get to pursue the question I wanted to a while ago, because my time expired. I asked you if there was any country in the world that had higher short-term Government rates than we have in the United States—and your reply was to Euro-dollars, selling for about 5.75, or 5¾.

Now, I do not consider that an answer to my question. That is not any one country but serves several countries.

How many countries are in Euro-dollars?

Mr. BARR. The Euro-dollar market is a market that has arisen in Europe, Mr. Chairman, that we happen to pay closer attention to than the rates in various countries. I would be delighted to supply for the record——

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The CHAIRMAN. But they represent a number of countries?

Mr. BARR. They are in essence U.S. dollars traded in a market in Europe. I would be delighted to supply for the record——

The CHAIRMAN. I know. But that is not an answer to my question. Name one country in the world where the short-term government securities of that country, the interest rates are higher than they are in the United States?

Mr. BARR. Well, the United Kingdom——

The CHAIRMAN. Short-term?

Mr. BARR. Yes, sir.

The CHAIRMAN. Thirty, sixty, and ninety days?

Mr. BARR. The problem you run into, Mr. Chairman, is that most countries do not have a short-term government market as we do in this country.

The CHAIRMAN. There is no country in the world, then, to your knowledge that has a higher short-term rate than we have?

Mr. BARR. The United Kingdom is one.

The CHAIRMAN. Well, let's see what it is.

Mr. BARR. May I supply it for the record?

The CHAIRMAN. I would like to have an answer now.

Mr. BARR. I don't have it now, Mr. Chairman.

Do we have anybody who knows what the United Kingdom's bill rate is today?

I am sorry, I cannot——

The CHAIRMAN. He has the record there.

Mr. BARR. He has a big book, but I don't think he has that.

The CHAIRMAN. What is the bank rate in Switzerland?

Mr. BARR. The bank rate in Switzerland is lower than the United States. It is around 4 percent.

The CHAIRMAN. What about Belgium?

Mr. BARR. Belgium just raised the discount rate. I don't know the short-term rate is. The discount rate is 5¼ percent.

The CHAIRMAN. All right. I will excuse you, since your book doesn't contain the information. You supply it. But don't pull any punches on it.

Mr. BARR. No, sir.

The CHAIRMAN. Thank you very much.

(The information requested may be found on p. 479.)

Mr. MOORHEAD. Mr. Chairman, may I ask one question?

Mr. Secretary, I would like to follow up on a thing that Mr. Weltner was talking about, which I understood the idea was to have a sense of Congress resolution that interest rates should not go above 5 percent for either savings and loans or banks or consumer CD's.

Now, my question, sir, would be—I think we are going to have some difficulty defining this—but my question would be, What would you think of a sense of Congress resolution that applied this 5 percent right across the board?

Mr. BARR. You mean——

Mr. MOORHEAD. It would be the sense of Congress that said savings deposits, CD's of any description of time deposit—none above 5 percent.

Mr. BARR. In any institution?

Mr. MOORHEAD. In any institution, and of any size.

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Mr. BARR. I would think it would have merit at this particular juncture. I think as a temporary solution, it has great merit, if applied up to something like $100,000.

Mr. MIZE. Would the gentleman yield?

Mr. MOORHEAD. I will yield to Mr. Stephens.

Mr. STEPHENS. I would like to ask a question along the line of what you mentioned there.

We would be setting a statutory 5 percent more or less. I would like to have a comment on this.

Aren't we headed that way anyway, but with some inequities? Because if we keep driving up the rate, we eventually arrive at the usury law in the State of Georgia, New York, and California, and they are not all the same. So we are going to be headed for that some time eventually, because in order to keep inequities from existing, if you are going to set interest rates right across the board, you will have a conflict with the usury laws.

Mr. BARR. That is correct. A very good point.

Mr. MIZE. Mr. Moorhead, do you mean this interest rate ceiling would apply only to savings—or do you suggest a straight 5-percent interest rate ceiling?

Mr. MOORHEAD. Savings, CD's, or any other type of instrument—that the sense of Congress be that would be the maximum.

Mr. MIZE. Would you envisage it applying to Government obligations, too?

Mr. MOORHEAD. No. I am thinking of banking institutions.

Mr. FINO. Mr. Chairman—following your question I would like to ask Mr. Barr—is there any country in the world that has lower interest costs in general to the corporate or individual consumer than the United States?

Mr. BARR. No, sir.

The CHAIRMAN. Just a moment. He is talking about consumer credit.

Mr. BARR. Would you rephrase the question. As I understand it, he said corporations or consumers.

Mr. FINO. Corporate or individual consumers.

Mr. BARR. There is no country in the world today.

The CHAIRMAN. You mean to say that we have lower rates than any country in the world?

Mr. BARR. Yes, sir. With the possible exception of Switzerland.

The CHAIRMAN. Switzerland, Belgium, many others have cheaper rates.

Mr. BARR. No, Belgium, Netherlands, Germany, Italy, France, United Kingdom, Japan——

The CHAIRMAN. In your testimony, when you look over your transcript, you put the rates in for the major countries of the world, on short term and long term.

Mr. BARR. Yes, sir.

Mr. FINO. The highest and the lowest.

Mr. BARR. Switzerland is the only exception.

The CHAIRMAN. The prevailing rate at the time of the information furnished.

Mr. BARR. Yes, sir.

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The CHAIRMAN. And we will have that information included at this point in the record.

(The following table was supplied by the Treasury Department:)

Short-term and long-term interest rates in selected countries

[In percent per annum]

	United States	Canada	United Kingdom	Federal Republic of Germany	Switzerland	Netherlands	France	Belgium
Central bank discount rate	4.50	5.25	6.00	5.00	2.50	5.00	3.50	5.25
3-month Treasury bill rate	4.67	4.98	5.52	[1] 6.15	[2] 4.06	5.00	[3] 4.88	[4] 5.50
Long-term Government bond yield	4.57	5.69	6.87	7.78	3.95	5.97	5.95	6.64

[1] 3-month interbank loan rate.
[2] 3-month deposit rate.
[3] Call money secured by private collateral.
[4] Auction rate on 4-month issues of Fonds des Rentes.

NOTE.—Date for foreign countries are the latest available, usually late May or early June. In some cases rates are not precisely comparable because of market and institutional differences. Except in the case of the United States and Belgium where May averages on long-term issues are used, long-term yields are based on the closing quotations for selected issues. The U.S. bill rate is also a May average.

The CHAIRMAN. The House is in session. Thank you very much, Mr. Barr. We appreciate your testimony.

Mr. BARR. Thank you, Mr. Chairman.

(Whereupon, at 12:03 p.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, June 8, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

WEDNESDAY, JUNE 8, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Gonzalez, Minish, Weltner, Todd, Ottinger, McGrath, Widnall, Stanton, and Mize.

The Chairman. Mr. Martin, I believe all the members of the Board are here with you, are they not?

Mr. Martin. Except Governor Brimmer, who unfortunately has a speaking engagement in Minneapolis.

The Chairman. The committee will please come to order.

This morning the committee continues hearings on H.R. 14026, to end the rate war between financial institutions.

Last week I announced that the committee would go into executive session tomorrow, Thursday, June 9, in order to try to report out a bill to stop this interest rate war immediately. However, due to the fact that the House meets at 11 this morning, we will have to ask you to come back tomorrow at 9 a.m., as we certainly cannot finish in just an hour, Mr. Martin. And we still are trying to get the bill ready to be marked up on Thursday. And we hope to report out one if we can.

We are glad, Mr. Martin, to have you and your colleagues with us, and you may proceed in your own way. First, if you will, identify your colleagues for the record.

STATEMENT OF HON. WILLIAM McCHESNEY MARTIN, JR., CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; ACCOMPANIED BY J. L. ROBERTSON, VICE CHAIRMAN; CHARLES N. SHEPARDSON, MEMBER; GEORGE W. MITCHELL, MEMBER; J. DEWEY DAANE, MEMBER; AND SHERMAN MAISEL, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Martin. Vice Chairman of the Board, James Lewis Robertson. On his left is Gov. Charles Shepardson, then Gov. George Mitchell, Gov. Sherman Maisel, and Gov. Dewey Daane.

If it is absolutely essential, Mr. Chairman, I will do it, but I have a scheduled meeting with the board of directors of the Federal

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Reserve Bank of Richmond tomorrow morning. This just applies to me. I am sure that the others will be available. So if you could complete your questions of me today it would be very helpful. It would be awkward for them, if I had to cancel at this juncture.

The CHAIRMAN. We will have to arrange it some way, as we have been doing in the past, Mr. Martin—we are always very glad to do it. This is a very important matter, as you know. It is more than just ordinary.

Mr. MARTIN. Right. And I will certainly cooperate.

The CHAIRMAN. Being Chairman of the Board, we rely upon your judgment on these matters, in addition to the other members of the Board.

Of course, if you have this engagement, and if we still need you, we will just have to arrange another time, I assume. It would all add up to delay in the consideration of the bill.

But we will do what you suggest on it, Mr. Martin.

Mr. MARTIN. You are always most cooperative. I just wanted to call your attention to that.

The CHAIRMAN. Yes, sir. Fine. You may go ahead, sir.

Mr. MARTIN. Mr. Chairman, on behalf of all members of the Board, I am making this statement relating principally to the issues raised in your letter of May 31. Since then we have had other letters which I will comment on later.

Let me first assure you that the Board shares the concern of the committee over the potential problem in the market for mortgages, with attendant effects on home construction.

There are mounting signs of unusual tightness in the mortgage market, although the avaliable statistics do not permit precise measurement of the difficulty of obtaining new home loans or its effect on residential construction. We believe the Congress would be fully justified in taking action to provide a cushion against too sharp a cutback in residential construction. We understand that your Subcommittee on Housing is now considering increasing the Federal National Mortgage Association's purchase authority. Direct injection of funds into the mortgage market through such traditional programs should prove much more effective in softening the impact on residential construction than any of the proposals for additional restrictions on time deposits.

It should be stressed that the difficulties currently faced by both financial institutions and the housing industry reflect, to an important extent, the result of principal reliance on general monetary policies rather than on fiscal actions to restrain the inflationary pressures of a booming economy. In the context of rapidly growing demands for credit, limitation of available credit supplies has been accompanied by higher interest rates on market securities, which has diverted flows of savings away from all intermediaries and directly into market instruments. Banks, as well as nonbank intermediaries, have felt the pressure of the rise in market rates. As noted in Governor Robertson's testimony of May 24, the growth rate of all financial institutions has slowed since the first of this year.

As a result of this diminution in the flow of savings to financial institutions at a time of rising credit demands, competition among intermediaries has increased. Savers are being offered higher re-

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turns for their funds, and new financial instruments have been devised to accommodate their requirements as to size and maturity of financial asset holdings. The small saver, in particular, has been courted by commercial banks and competing institutions, and has had the opportunity of sharing in the larger rewards for thrift.

The Board regards increased competition among financial institutions as a development that has important economic benefits. Over the long run, increased competition contributes to a more efficient functioning of our financial markets and to an improved allocation of real resources, while fostering innovations in financial technology. The development of the negotiable certificate of deposit into an important financial instrument meeting investors' needs, and at the same time channeling funds to productive uses, is a case in point.

In the short run, however, structural shifts in financial flows may take place so rapidly as to generate adjustment problems for individual financial institutions and for the borrowers they finance. This year, in the context of general restraint on credit expansion, the more active competition of banks for savings funds has impinged directly on the flow of savings to some nonbank intermediaries. These institutions, in turn, have curtailed their new commitments of funds to the mortgage market.

Shortrun problems that emerge from the heightened competition are most appropriately handled, the Board believes, by temporary solutions designed to facilitate adjustments of the nonbank financial institutions and the mortgage market, rather than by permanent restrictions that tend to freeze existing relationships and to limit competitive freedom. In this respect, the Board welcomed administrative rulings made earlier this year by the Federal Home Loan Bank Board relaxing liquidity requirements for savings and loan associations and increasing the freedom of these institutions to compete with commercial banks for savings. It also welcomes the legislative proposal to increase the funds available to the Federal National Mortgage Association.

It might also be desirable to facilitate gradual adjustments to a changed competitive environment by increasing the scope of the Board's authority to specify the ceiling rates on, and reserves held against, commercial bank time deposits. For example, the Board would welcome greater flexibility in the extent to which reserve requirements could be used as an effective tool of monetary policy. A change in the statutory range of required reserves for time deposits (other than passbook savings) might be useful; a range of 3 to 10 percent would give considerably greater flexibility than now exists.

Increased flexibility of this kind could be utilized more effectively if the proposed amendment permitted grdauation of reserve requirements by size of bank. Graduated reserve requirements, as the Board has indicated in its past annual reports, would greatly improve the competitive position of small banks. Equivalent requirements also should be extended to all insured commercial banks so that the reserve burden would be shared by all banks enjoying the benefits of deposit insurance.

It would be a serious mistake, however, at this time of great economic uncertainty—when financial markets are in a taut and nervous state and the course of future events is so largely dependent on Viet-

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nam developments—to require by law a doubling of reserve requirements against time deposits before the end of 1966. Such a provision would reduce, rather than enhance the Board's flexibility in meeting changing economic developments and would run the risk of generating much harsher restraint on economic activity than the prevailing situation called for.

Moreover, the Board feels it would be unwise to set the minimum of the requirement range as high as 8 percent on deposit liabilities of fixed maturity.

On the question of prohibiting shorter maturities for time deposits, the Board sees no merit in setting a minimum as long as a year or even 6 months. It would unfairly penalize many small banks, especially in some Midwestern States where time deposits are customarily used in place of passbook savings accounts. It would also penalize many investors by depriving them of the choice of a financial asset of proven acceptance. A minimum maturity as long as 6 months is not needed to effectuate the prohibition of payment of interest on demand deposits.

Prohibiting all shorter term time deposits would force sharp adjustments in money markets. Banks are already paying close to the present 5½ percent ceiling on 3- to 4-month money in the market for large-denomination CD's. According to our latest CD maturity survey, over 80 percent of the outstanding large negotiable CD's will mature in the next 6 months. Thus, with the present ceiling rate of 5½ percent, a prohibition against issuing CD's of less than 6 months maturity might cause banks to lose a large portion of these deposits over the next 6 months. Even with a higher ceiling on longer term CD's, banks might still lose a substantial part of these deposits, because investors may be unwilling to commit funds for as long as 6 months.

A sudden withdrawal of funds from the CD market would force many banks into sweeping portfolio adjustments, and under present circumstances might create chaotic conditions in the money and capital markets. Assets liquidated by banks would not necessarily be those sought by corporate funds seeking alternatives to CD's. The result might be sharp discontinuities in the supply of funds available to some sectors of the economy. State and local governments, small business borrowers, and homebuilders and buyers might well be the principal sufferers.

It is clear, therefore, that any proposals intended to limit the range of competition among intermediaries for small savings must be carefully drawn to avoid serious disruption of flows of funds in the well-developed money and capital markets. In this respect, the proposal to distinguish between time deposits according to their size, for purposes of establishing rate ceilings, may be worth considering. Today, large-denomination negotiable CD's and time deposits of smaller denomination sell in relatively distinct markets. Most buyers of large-denomination CD's are very large investors, including nonfinancial corporations, foreign depositors, State and local governments, and pension funds. Small denomination time deposits, on the other hand, serve as a savings medium for individuals, and as an investment medium for small businesses and municipalities.

Legislative authority for the Board to distinguish temporarily between these two markets in setting ceiling rates might in some situa-

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tions facilitate actions to smooth the transitory adjustment problems of competition for savings funds in smaller amounts without disrupting flows of funds in the money and capital markets. The size of the deposit that divides these two markets cannot be stated precisely, however, and it might be possible to distinguish effectively between them, for purposes of establishing rate ceilings, drawing the line at a deposit size either smaller or larger than $100,000.

The Board believes that the determination of ceiling rates, and differentials in rates, should be left to administrative discretion, thereby permitting adaptation of the ceilings to changing circumstances. Financial market pressures can and do change rapidly; a ceiling rate fixed by law would be much more difficult to adapt to the changing credit needs of the economy. For example, the ceiling rate of 4½ percent on time deposits under $100,000 suggested in the letter of May 31 from Chairman Patman is far below rates currently available in the money market for such risk-free instruments as U.S. Government and U.S. agency obligations. It is also below the rates available from competing deposit institutions. Such a ceiling would threaten the present and future availability of funds to borrowers heavily dependent on the banking system.

Preliminary indications from a recent survey conducted by the Board indicate that such a ceiling would be injurious to many small banks. By raising their rates to over 4.5 percent, smaller banks have been able to compete with the money market and other savings institutions. The largest percentage of banks that would suffer serious losses of funds would be those in growing areas of the country—in States such as Texas, California, Arizona, and others which for many years have had to pay higher rates on deposits in order to attract savings to capital-short areas.

Our survey also shows that banks paying over 4.5 percent on time deposits other than large negotiable CD's report more than $6.5 billion in deposits of the type which would be restricted by the proposed ceiling. Forcing them to roll back rates offered to the 4.5 percent level would almost certainly cause them to lose a significant portion of these funds. It would also make it impossible for them to compete effectively in the future. Such a ceiling probably would have the effect of penalizing most the growing and capital-short parts of the country, and the attendant loss of access to credit facilities by small businesses and other borrowers heavily dependent upon these banks might be more serious than the problems the committee is now seeking to resolve.

That covers, Mr. Chairman, your letter of May 31. I might just briefly go over your letter of June 6, which we received yesterday, and all the members of the Board are here and available for comment on any of these points.

The first proposal in your letter would increase the range of required reserves on time deposits from 4 to 10 percent. We see no objection to that.

Second, increase the minimum maturity on time deposits from the present 30 to 90 days. We have the authority to do that now. At the present time we have not decided to do that. But we have the authority.

Third, lower the maximum interest rate payable on time deposits from 5½ to 4½ percent but permit renewal of all present obligations

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at the contract rate. We would be opposed to that. We don't think that corporate treasurers using CD's can be expected to hold them indefinitely; this is an in-and-out market, depending on corporate needs for cash. And we don't believe that this would be a satisfactory method of handling the problem of a drastic contraction in outstanding CD's.

Fourth, permit open market purchase by the Federal Reserve System of any obligation which is a direct obligation or are fully guaranteed as to principal and interest by any Federal home loan bank. This is a matter that we are currently studying, and we think it requires a good bit of additional study.

As you know, obligations of the Export-Import Bank and certain other agencies are eligible. I will submit for the record a legal memorandum on obligations of Government agencies eligible for purchase and as security for advances by Reserve banks.

The CHAIRMAN. We will place that in the record at this point.

(The document referred to follows:)

BOARD OF GOVERNORS,
LEGAL DIVISION (R. P. FORRESTAL),
April 13, 1966.

Subject: Obligations of Government agencies—eligibility for purchase and as security for advances by Reserve Banks.

This memorandum is for information only and requires no Board action.

On January 14, 1966, the Board decided that participation certificates issued and guaranteed by the Export-Import Bank of Washington ("Eximbank") are obligations fully guaranteed by the United States as to principal and interest and are, therefore, eligible for purchase by Reserve Banks under section 14(b) of the Federal Reserve Act, and as security for advances under the eighth paragraph of section 13 of that Act.

In reaching this decision, the Board relied primarily on an opinion of the Attorney General of the United States,[1] which held that an obligation guaranteed by a Government agency is fully guaranteed by the United States as to principal and interest.

As the Board may recall, the language of the Attorney General's opinion is quite broad:

"A series of opinions of the Attorney General issued between 1953 and 1959 has established that a guaranty by a Government agency contracted pursuant to a congressional grant of authority for constitutional purposes is an obligation fully binding on the United States despite the absence of statutory language expressly pledging its 'faith' or 'credit' to the redemption of the guaranty and despite the possibility that a future appropriation might be necessary to carry out such redemption." (Footnotes omitted.)

During its consideration of the Eximbank matter, the Board expressed some concern at the implication of its decision for open market and discount operations. Accordingly, it requested the Legal Division to prepare a memorandum specifying those Government agencies whose obligations would be considered eligible for purchase by Reserve Banks under section 14(b) and as security for advances under section 13, in light of the Attorney General's opinion and the Board's Eximbank decision.

In response to that request, this memorandum sets out those Government agency obligations (1) eligible for purchase by Reserve Banks either under a specific statutory provision pledging the faith and credit of the United States to the obligations, or eligible for purchase under the principle announced in the Attorney General's opinion; (2) ineligible for purchase; (3) ineligible as security for advances; and (4) eligible as security for advances.

The lists of agency obligations which follow are not intended to be exhaustive. They are based on obligations which have been issued in the past or are presently outstanding. Other agencies might, of course, issue obligations which would fall into any of the categories enumerated below.

[1] 42 Op. A.G. No. 1 of April 14, 1961.

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(1) Obligations eligible for purchase under section 14(b)

(a) *Obligations guaranteed by statute.*—The following Government agency obligations are fully guaranteed by the United States as to principal and interest by virtue of specific statutory provisions pledging the faith and credit of the United States to the redemption of the obligations. The statutory references are contained in parentheses:

D.C. Armory Board (72 Stat. 421).
Farmers Home Administration (7 U.S.C. 1928).
Federal Housing Administration (12 U.S.C. 1710; 1713; 1715e; 1715h; 1715m).
Commodity Credit Corporation (15 U.S.C. 713a–4).
Federal Farm Mortgage Corporation (12 U.S.C. 1020c).

(b) *Obligations governed by Attorney General's opinion.*—The following Government agency obligations are considered fully guaranteed by the United States as to principal and interest, despite the absence of express statutory language pledging the full faith and credit of the United States, by virtue of the principle announced in the Attorney General's opinion above quoted:

Export-Import Bank of Washington.
Federal Crop Insurance Corporation.
Rural Electrification Administration.
St. Lawrence Seaway Development Corporation.
Small Business Administration.
The Maritime Administration.
Virgin Islands Corporation.

It must also be borne in mind, of course, that any executive department or agency of the Government which possesses or obtains statutory authority to issue or guarantee obligations would seem to be included within the ambit of the Attorney General's opinion. Consequently, such obligations would be considered fully guaranteed obligations of the United States unless Congress expressly disclaims general liability.

(2) Obligations ineligible for purchase

(a) *Obligations issued by quasi-Federal agencies.*—The following obligations issued by Federally sponsored institutions are not fully guaranteed by the United States since these instrumentalities are not Government agencies as that term is used in the Attorney General's opinion:

Banks for Cooperatives.
Federal Home Loan Banks.
Federal Intermediate Credit Banks.[2]
Federal Land Banks.

(b) *Obligations not fully guaranteed by the United States by virtue of specific statutory provision:*

Federal National Mortgage Association (12 U.S.C. 1721(b)).
Tennessee Valley Authority (16 U.S.C. 831n–4).

(3) Obligations ineligible as security for advances

The eighth paragraph of section 13 provides that a Reserve Bank may accept as collateral to advances any "notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks under the provisions of this Act."

Section 14(b) of the Federal Reserve Act provides that a Reserve Bank may purchase "any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest * * *."

As discussed in previous memoranda dealing with obligations of Eximbank and the Small Business Administration,[3] the Board has held that not every obligation eligible for purchase is automatically eligible as security for advances. On the contrary, the Board has specified that only those obligations contemplated by the eighth paragraph of section 13, namely, notes, drafts, bills of exchange, and bankers' acceptances, will be considered eligible collateral to advances. In view of this position, only the obligations listed above as eligible for purchase which are also of the kind contemplated by the eighth paragraph of section 13

[2] The obligations of this institution may be purchased pursuant to section 13(a) of the Federal Reserve Act if their maturities do not exceed six months.
[3] Legal Division memoranda dated January 14 and March 1, 1966.

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will be eligible as collateral to advances. Thus, any obligation which is a "security" [4] will *not* be eligible as collateral to advances.

(4) *Obligations eligible as security for advances*

Notes, drafts, bills of exchange, and bankers' acceptances issued or guaranteed by the agencies listed in No. (1), above, are eligible as security for advances as they are fully guaranteed by the United States.

In addition, obligations of Federal Intermediate Credit Banks which are expressly made eligible for purchase by Reserve Banks under section 13(a) of the Federal Reserve Act are also eligible as security for advances.

It is also possible that some agency obligations would be eligible as security for advances if they were eligible for discount under section 13, or if they otherwise met the requirements of Regulation A. This was true, for example, of Commodity Credit Corporation certificates of interest which the Board recently held to be eligible under the provisions of the Regulation.

* * *

Because of the impossibility of predicting exactly what form future agency issues might take, it would be desirable to examine agency obligations on an individual basis prior to any decision or announcement by the Board concerning the eligibility of such obligations for purchase or as security for advances.

Mr. MARTIN. What I want to emphasize here is that we don't have always as good a Government securities market as we would like to have. In purchasing securities, we are supplying high-power dollars. Now, it is true it doesn't make too much difference how we supply them, except that if you are going to assume responsibility for these markets, you are going to further dilute the overall market, and the use of these obligations in this way and the supplying of high-powered dollars this way places additional pressures upon the money managers with respect to how they manage the money supply. And this is something that we ought to be very careful about and recognize that there are dangers in it.

We are not saying this is something that ought to be cast aside out of hand, but I, for one, as Chairman of the Board, see very serious dangers in it.

The CHAIRMAN. Mr. Martin, I would like to ask you some questions. Have you concluded?

Mr. MARTIN. I have concluded, right.

The CHAIRMAN. Yes, sir. Now, anything additional you desire to insert in the record to elaborate on this, you may be free to do so.

Mr. MARTIN. Thank you very much, Mr. Chairman.

The CHAIRMAN. This issue resolves itself down, as I understand it, to whether the Board will do these things, or whether Congress by law should compel them.

The trouble, as I view it, started December 6, 1965, when the Board, as the newspapers stated all over the Nation, defied the President—and I personally look upon it that way, too—and went ahead and raised these rates by as much as 37½ percent. The most devastating rates, of course, were in the category from 4- to 5½-percent increase, which is 37½ percent.

Now, then, many people believed that this was a direct attack on the thrift institutions. The commercial banks failed to provide for homebuilding funds back in 1932, and under Mr. Hoover, the Federal Home Loan Bank Board was created, which was set up

[4] The Board has held, for example, that Merchant Marine Bonds, although technically notes, were clearly what are generally regarded as securities, and did not constitute the kind of notes contemplated by the provision authorizing advances to member banks secured by "notes, drafts, bills of exchange, or bankers' acceptances" eligible for discount or purchase by the Federal Reserve Banks. (1960 Bulletin 151.)

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to assist the buildings and loans all over the Nation—these became savings and loan associations. These savings and loan associations became very successful in building homes over the country—and we are so deeply obligated to them for their success, and for their achievements in that direction—they have now become a $130 billion industry.

Now, it is known that many commercial banks have not looked with great favor upon that achievement. At the time of the creation of the Federal Home Loan Bank System, commercial banks were not pushing homebuilding. And even now, when the banks are asking that these high rates be maintained, which many of us believe the savings and loans cannot pay. So, if these rates are not relaxed or changed in some way, the banks that are fighting for these high rates are still not offering to do anything in the way of helping homebuilding. They are just not interested in doing that.

So I think that careful consideration should be given to the course that the Federal Reserve Board adopted December 6.

Now, is the Board in a position to indicate any change in those regulations that would make it possible for homebuilding to resume in this country, Mr. Martin?

Mr. MARTIN. The Board policy is clearly outlined in the weekly figures that are given out every Friday. And there has been no change in it.

The CHAIRMAN. I know. But the figures don't tell any story to us.

Mr. MARTIN. Oh, the figures, I think, are very revealing, Mr. Chairman.

The CHAIRMAN. What do you say that they reveal? Give us an interpretation.

Mr. MARTIN. Well, they reveal a moderately restrictive monetary policy with real pressure on the money market.

The CHAIRMAN. Moderately restrictive. Don't you think this is a tight money market?

Mr. MARTIN. I think it has gotten progressively tighter. But we still have a larger money supply than a good many of us would like to see. This is one of the difficulties.

The CHAIRMAN. You know, this is getting very serious, Mr. Chairman.

Now, during 8 years of the Eisenhower administration, you were given the power to do anything you wanted to do, the Board had its independence recognized. The first time it was ever recognized. Mr. Truman resisted, and I supported him. No other President ever recognized the independence of the Fed until Mr. Eisenhower. And during that time, when you had full access to anything you wanted, you had three recessions—one right after another, one every 2 or 3 years.

Now, since the Democrats came in on January 20, 1961, we haven't had any ups and downs—we have had a pretty stable economy, and everything has been going along pretty well, no recessions, five and a half years and no recessions—although we had three under Eisenhower. And it occurs to me that the Board is just determined to have a recession. I cannot understand why you would want to have a recession. But when you raise the rates 37½ percent, that was highly inflationary in my book.

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And of course that type of inflation could only lead to a recession later on.

So I just cannot understand what the Board has in mind by wanting a recession every few years. Would you explain?

Mr. MARTIN. I can assure you that the Board's actions are not to create a recession, but to prevent a recession.

The CHAIRMAN. You admit there were three under Mr. Eisenhower in 8 years—when you had full control—Mr. Eisenhower said, "Go ahead."

Mr. MARTIN. You assume, Mr. Chairman, those recessions were caused entirely by monetary policy. I could spend a lot of time debating the point. But I would insist that monetary policy was a very minor element in those recessions, and where monetary policy should be criticized is that it was late in bringing about the stability in prices that are required for adequate growth.

Let me point out that if we had not broken the back of inflation, I don't believe we would have had the price stability that started off in 1961, and which until the summer of 1965 has been one of the great achievements of the Kennedy and Johnson administrations. The Board has done everything it can to promote that price stability.

The CHAIRMAN. You say if you had not broken the back of that recession. Which recession are you talking about?

Mr. MARTIN. I am not talking about recession—inflation. If we had not broken the back of the inflation in the fifties. And let me just correct the record here. We did not have carte blanche to do anything we wanted under the Eisenhower administration. I had a number of very serious battles during that time over these matters of judgment. Honest men differ on judgments at different times. But there was no carte blanche then any more than now.

The CHAIRMAN. But three times you saw inflation, and you were trying to stop inflation three times, and you had a recession each time. That is correct, is it not?

Mr. MARTIN. A recession always follows an inflation that gets out of hand. And this is what we are trying to prevent now. If inflation gets out of hand now, we are going to have more than a pause—we will have a recession, because we have not dealt with the inflation. This is the inevitable course of events in the economy.

The CHAIRMAN. This point is aside just a little bit—although it is relevant.

We have a bill that will come up from this committee next week on the floor of the House, the extension of the Defense Production Act of 1950, H.R. 14025. This committee has an amendment, to give standby credit control authority to the President.

Do you believe, just offhand, without too much discussion—that might be a wise thing or an unwise thing, Mr. Martin—to give the President standby authority to deal with consumer credit?

Mr. MARTIN. I have long felt that there is real merit in selective controls. But unless those selective controls are buttressed by general controls, I think they are ineffective. And I think there is always a tendency to want to use the selective controls as a substitute for the general controls.

The Congress repealed authority for regulation W in 1952, although the Board recommended that it be continued for use as needed. If we

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had it on a standby basis, I think it might at times be useful. But I do not think selective controls can ever substitute for general controls.

The CHAIRMAN. But don't you realize, Mr. Martin, that you cannot effectively enforce general controls, prices, and wages, about 8 to 10 million of them—price and wage controls which we had them in World War II—you cannot effectively enforce those controls unless you have a patriotic fervor. In war, when our future doesn't look so good, and everyone is patriotic, and we are willing to do everything that is necessary. But when that excitement dies down, don't you know it is almost impossible to enforce those controls?

Mr. MARTIN. I do, indeed. We have had that experience at the Board.

The CHAIRMAN. We had an experience which is an unfortunate one. Of course black markets grew up, and terrible things happened.

Mr. MARTIN. You and I have agreed on this on several occasions.

The CHAIRMAN. Yes. But don't you think it is desirable that the President use every power, like moral suasion, or any other proper power, to try to keep prices and wages down without even having selective controls?

Mr. MARTIN. I have no objection to the President using all of his hortatory and persuasive powers at all times for the welfare of the country. And I am sure he has been doing that.

The CHAIRMAN. Don't you think that if he had the power from Congress to put into effect controls on consumer credit, for instance, which, of course, is one of the important ones—that this would be a shotgun in the corner, just to be used in the case of absolute need—don't you think that this would help him in trying to get results by moral suasion?

Mr. MARTIN. I think it would be—it would not be moral suasion—it would be statutory suasion.

The CHAIRMAN. Well, of course, it would not carry any penalties, could not put anybody in jail or fine them necessarily.

Mrs. Sullivan, I will yield to you. You are next.

Mrs. SULLIVAN. Thank you, Mr. Chairman.

Mr. Martin, and gentlemen, I am disappointed that the Board doesn't seem to be aware of the gravity of the situation now existing. It seems that the bankers themselves are urging restraint even more so than the agencies supervising the banks. Again, the supervisors don't seem to recognize that there is a serious problem.

I would like to have inserted in the record, Mr. Chairman, if I have your permission, some news articles—I will read the headlines.

"Bankers Must Accept Major Responsibility for Future of Present Financial System." This comes from the American Banker.

"Plummer Urges Restraint on CD Rates." This comes from Jacksonville, Fla.

"Treiber Warns NJBA on CD Dependence." This comes from the American Banker, Atlantic City, N.J.

"Bankers Warned To Use Caution in Promotion of CD's." This comes from Cincinnati, Ohio.

"Deming Cautions on Bid for Funds." This is from Washington, D.C.

And "Chicago Bank's Ads Hit 'Rate Race,' CD's." This comes from Chicago, Ill.

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The CHAIRMAN. Without objection, so ordered. They may be inserted.

(The articles referred to follow:)

[From the American Banker, May 19, 1966]

BANKERS MUST ACCEPT MAJOR RESPONSIBILITY FOR FUTURE OF PRESENT FINANCIAL SYSTEM

The urgent needs for bankers to accept full responsibility now, specifically by exercising restraint in the use of their competitive advantages, was asserted vigorously by Archie K. Davis, president, American Bankers Association, and chairman, Wachovia Bank & Trust Co., Winston-Salem, N.C., in a speech this week before the annual convention of the Arkansas Bankers Association. In the speech Mr. Davis discussed specific ways in which bankers could exercise restraint in lending; and he also warned bluntly against continuation of the existing rate war, and named both savings and loan associations and smaller banks as potential victims which must be spared in order to preserve the financial structure as it now exists.

One of the most pleasant aspects of serving as an official in your American Bankers Association is the opportunity to visit with bankers throughout the country. In recent weeks my fellow officers and I have talked with literally hundreds of bankers from almost every State in the Union. Although we have found that business activity continues at a high level in almost every area, these conversations have been dominated by one salient and highly disturbing theme. That theme is this: almost all thoughtful bankers are profoundly concerned about the developing monetary and credit situation, and especially the implications of the highly competitive race among banks and other financial institutions for savings. Equally significant is the fact that individual bankers, in attempting to deal responsibly with these problems, are beset by a deep sense of frustration.

For several months the indicators that provide early warning signals of inflationary excesses have been pointing strongly upward. More recently these earlier warnings have indeed been confirmed by evidence of rising consumer and wholesale prices. Inflation is no longer simply a danger; inflation is here. Bankers know that this can only further impair our balance of payments position, which is not improving in line with the January forecasts of the Administration. Rising prices will seriously affect those citizens least able to defend themselves—namely, pensoners and others who live on fixed incomes. In addition, inflationary excesses could well terminate the prolonged business expansion, which got under way in early 1961, and result in recession and unemployment.

Why does the individual banker feel frustrated in this situation? Because present and prospective Federal government policies do not seem to recognize or accept the task of containing inflation. I refer particularly to Federal fiscal policy; the unfortunate fact is that Federal domestic welfare spending continues to rise sharply even though expenditures for Vietnam have increased much faster and farther than anyone foresaw.

This attempt to have both "guns and butter" without adequately footing the bill, in terms of fiscal restraint, has fed the fires of inflation. The Federal Reserve authorities, charged with the clear duty of protecting the dollar, have had no choice but to permit credit conditions to tighten markedly as loan demands have mounted rapidly to unprecedented levels. Reflecting these conditions, both interest rates and bank loan-to-deposit ratios have risen to the highest level since the 1920's.

In recent weeks, the main thrust of the Administration's anti-inflationary policy has been in the form of exhortation of the business and financial community to exercise voluntary restraint in the public interest. Such exhortation is not inappropriate and, speaking for the banking industry, I am certain that bankers everywhere will do their utmost to cooperate with the Administration. I must in all candor state, however, that the exhortations would doubtless be even more effective if the Administration would set a proper example for the business and financial community by exercising the same type of discipline and restraint it is asking of others.

But even though this example is lacking, the banking community has a compelling duty to the American people to do everything in its power to maintain the value of their money and to sustain the business advance. Surely this type

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of voluntary action in the public interest is preferable to mandatory programs. In any event, this type of approach is only natural to an industry, such as banking, which is so highly attuned to the public interest.

The problem of establishing and implementing such a program adds further to the individual banker's frustration. He simply may not know how he should adjust his lending policies to serve this broad public purpose while also serving the legitimate interests of his customers and stockholders. It was in recognition of this fact that, a few weeks ago, I asked the chairman of the ABA's banking and financial research committee to attempt to devise a set of suggestions that might be useful to the management of banks, large and small, in making decisions as to loan applications. All of us on the firing line in bank lending operations know that today there is simply not enough money available to meet all loan demands—that many of the requests which must be turned down are not marginal applications, but are from good customers who need to finance sound projects.

The hard fact is that we must select; we must allocate—and we need to do so on the basis of logical and equitable principles that will serve both the needs of our customers and the economy. The chairman of the banking and financial research committee, Wesley Lindow, who is also executive vice president of the Irving Trust Co. of New York, appointed a special subcommittee to handle this project. His group has developed what seems to be an excellent set of suggestions, and I wish to thank them sincerely on behalf of the industry.

The entire statement of Mr. Lindow's special group is being released along with my speech today. May I take a few minutes to summarize the statement, which consists mainly of 10 questions that bank managements would do well to review before allocating funds among competing borrowers.

At the outset, the committee emphasizes that no simple set of rules can apply to every bank, or even to the same bank at different periods of time, nor can any one criterion be used as a guide. This is good advice which bankers will do well to heed. In approaching the theory and vexing problem of how to spread the limited amount of available bank credit among customers, bankers should carefully consider a wide range of questions.

First, is the banker certain that the needs for productive credit are being fully met? If some loan requests must be rejected because demand exceeds the supply of available funds, bankers should strive to meet the legitimate needs for productive loans—those that would add relatively quickly to the economy's capacity to produce goods and services—and screen out the loans that do not meet this fundamental test.

Second, is the banker discouraging speculative inventory loans? Loans to carry inventory acquired in anticipation of price increases are a good example of speculative credits whose spending adds directly to inflationary pressures. Equally significant, however, is the fact that a bank should, in its own self-interest, tighten inventory loan policies when funds are in short supply, thus permitting the bank to meet more of the needs of other good customers and perhaps avoid future difficulties if recession were to set in.

Third, is the banker devoting careful and appropriate attention to plant and equipment loans? Although some capital spending programs will facilitate rapid expansion of productive capacity in critical lines, many will not and, in the interest of avoiding inflation, might well be postponed. Thus the banker will want to consider carefully the impact of the project on productive capacity in the near future. Moreover, careful bankers must exercise independent judgment as to the financial soundness of the proposed capital expenditure. When economic activity is at peak levels, as is the case today, many bankers will want to tighten policies with respect to such loans in order to offset increased risk exposure that would result from a slackening in peak activity.

Fourth, is the banker discouraging loans for take-over purposes? Only in rare cases will loans to finance the acquisition of going concerns result in a quick expansion of total output in the economy. Such loans can, of course, be exceedingly good credits under normal circumstances, but under today's conditions many bankers who recognize the need for holding down inflationary pressures will discourage them in favor of more productive credit extensions.

Fifth, is the banker carefully screening loans which will affect this nation's balance of international payments? Bankers are continuing to give strong and active support to the Administration's voluntary program for restraint in foreign lending, and the record has indeed been impressive. Care should be taken, however, to give special consideration to loans which encourage exports and thereby strengthen our balance of trade. Still, in the interest of equity, any

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restrictive criteria applied to domestic loans should also be applied to foreign loans.

Sixth, is the banker taking firm action to upgrade the quality of loans that are granted? Raising quality standards is good business for bank and good business for the economy; it will help counter the excessive optimism that tends to develop when economic activity is high, place the bank in a stronger asset position in the event business activity slackens, and substantially assist in the bank's efforts to spread its limited funds among borrowers.

Seventh, is the banker atcively working to pare down loan requests by "whittling" or deferment? To the extent loan demands can be reduced or deferred, the legitimate needs of a larger body of customers can be served.

Eighth, is the banker advising the customer, where feasible and desirable, to shift his borrowing to other channels? In many instances appropriate private placements or public bond issues will serve the customer effectively and fully. In addition, the possibility of equity financing should not be overlooked.

Ninth, is the banker taking care not to overextend his lending operations geographically? Many bankers are, quite understandably, anxious to spread their markets by lending in new areas. The careful banker recognizes that the chance of costly errors of judgment in lending outside his local area is at a maximum when business activity is high.

Tenth and finally, is the banker properly screening new applications for loans? The problem of screening the needs of new customers, as compared with those of long standing, is particularly difficult when economic activity is strong and credit demands exceed supply. In such screening, the banker should give careful attention to the national economic scene, and to the mutually profitable aspects of the prospective relationship in the light of other long-established customer relations.

The foregoing represents a brief and admittedly inadequate summary of the special committee's recommended suggestions, and I assure you that the entire statement is worthy of careful study. You will find in it valuable suggestions on how to implement such a program of reasonable restraint within your bank, as well as many thoughtful observations on the relation of such a program to over-all monetary policy, including competitive implications. The statement will be mailed to all ABA member banks within a matter of days, and I strongly urge each chief executive officer to discuss its contents with senior management and lending personnel. Again, I want to thank Wesley Lindow and his associates for a job very well done; banking is in their debt.

The problem of coping with excessive loan demands is, however, only one side of the equation which bankers are finding so difficult to balance. The other side of the equation—which has serious implications for the stability of the entire financial and economic structure—relates to deposit acquisition and time money. Here again bankers are experiencing a feeling of lonely frustration. We know that the inordinately competitive rate war which has developed—and it is indeed a rate war—is highly dangerous; but, as individuals, we do not know precisely how to cope with it. The banking and financial system is highly competitive. Even though sound competition for savings can benefit all involved, unsound and unbridled competition, coupled with an upward spiraling of interest rates, can result only in trouble for banks, for their competitors, and for the financial structure and the economy.

The unhappy situation in which we find ourselves is not going unnoticed in Washington, and I am not divulging confidential information when I tell you that there is deep and genuine concern in the Congress and in the agencies as to where this present unbridled competition will lead. Only last week, the House Banking and Currency Committee started hearings on a proposal by its chairman, Representative Wright Patman, to prohibit banks from issuing any negotiable certificates of deposit whatsoever.

This is a drastic step which, in my judgment, would do much more harm than good. But the significant fact is that Congress is deeply concerned, and some type of legislation aimed at dampening savings competition may well pass in this Congressional session.

The fundamental fact is that we are faced with the possibility of additional regulatory legislation, and the task confronting us is to make certain that such legislation does not impinge upon individual or institutional rights, does not create unfair competition for banks and does not damage the economic and financial structure. Although some sort of legislation may be forthcoming—and, if so, we shall work diligently to make it acceptable to the commercial

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banking industry—the responsibility of the individual banker for statesmanship and leadership is not in the least diminished.

Some bankers—a minority, I am sure—view with considerable satisfaction the competitive advantage that our industry is enjoying over the savings and loan industry. I suggest that this satisfaction is mistaken and may well be short-lived. No one—banks, savings and loan associations, or anyone else—can gain from sustained destructive competition which gives rise to substantial transfers of funds among competing industries and institutions. The fact that for 20 years the commercial banks were the disadvantaged competitors as compared with the savings and loan associations is wholly beside the point. Any major dislocations that impinge upon the effective capacity and soundness of the savings and loan industry will also affect our own industry.

In addition, the destructive competition which has been taking place has serious implications for the competitive position of small banks as compared with their larger competitors. At this time, there are no clear data which show precisely how the flow of funds between small and large institutions is affecting their respective positions. Discussions with financial leaders in various sections of the country indicate that there is no uniform trend with respect to such shifts. However, this situation should be clarified within the near future when the results of special surveys made by the Federal Reserve and FDIC have been tabulated.

To sum up, what we are confronted with under today's conditions is a rapidly changing distribution of resources within the financial industry. Just as water seeks its lowest level, money seeks its highest return. The national interest, our dual system of banking—so deeply rooted to community requirements through thousands of small individual unit banks—and the broad base of residential mortgage financing represented by thousands of federally and state-chartered savings and loan associations—all are involved, and the nation has a vital stake in preserving their stability as sound and prosperous institutions.

Only harm can come to the national economy through sudden and serious dislocations of financial resources brought about by destructive and unrestrained competition. No segment of the nation's economy would be exempt from repercussions resulting from the impairment of any part of the financial system.

For 30 years our dual commercial banking system has displayed rare versatility and ingenuity. It has played a vital role in the postwar economic development of this country. Even in 1965 it was doing an outstanding job and, by any standard of measurement, was operating in the national interest, by affording such strong financial support to a burgeoning economy. Retrospectively, it now appears that in the light of the Vietnam escalation and other rapidly expanding domestic programs, perhaps the banking system was overly contributing to the money supply through credit and thereby feeding the fires of inflation.

Repeatedly, by exhortation from all quarters, bankers are being urged to slow down. The test of banker capability, in a very complex and competitive financial community, to exercise restraint and sound judgment on a voluntary, individual basis is now at hand. The opportunity for the banker to acknowledge his responsibility to the public good, within the framework of private enterprise, is also at hand. The manner in which the banker accepts this responsibility may determine whether the dual system of banking will be permitted to continue as presently constituted.

It is therefore abundantly clear that our banking system, through individual bankers, must exercise the highest degree of managerial responsibility under today's trying conditions. The national interest demands it. Banking's own interest demands it.

[From the American Banker, Mar. 29, 1966]

PLUMMER URGES MORE RESTRAINT ON CD RATES

JACKSONVILLE, Fla.—"The banking fraternity appears to be confusing the certificates of deposit market with passbook savings," and the results could be "disastrous in terms of cost," Frank A. Plummer, president of First National Bank of Montgomery, Ala., warned here Monday.

He suggested to the bank comptrollers and operations people attending the 31st eastern regional conference of NABAC, The Association for Bank Audit, Control and Operation, that they urge greater restraint on the part of their managements in issuing CDs and increasing their rates in attracting new funds. "We may be going too far too fast," he said.

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Mr. Plummer noted that the higher rates on time money paid by banks in competing with savings institutions, mounting operating costs and high turnover of demand deposits, constitute a problem area which operating people should make known to senior staff. They must inform management how much it costs to use this money, he added.

Other problem areas which Mr. Plummer cited are:

● Loss of liquidity. "Before the end of 1966, I have an idea that bank management and loan and investment portfolio managers will spend many wearisome hours together," he noted.

● Fears of loan deterioration. "Concern about consumer loans and mortgage loans has been evident, but the real losses could be deterioration of commercial loans. More attention with respect to the wheelers and dealers is needed in this area." Mr. Plummer said bankers must pay more attention to insuring better quality in loans.

The Alabama banker noted that in the future electronic data processing will provide institutions with a tool for improving many banking functions "in areas where we have not yet scratched the surface." He suggested banks "fatten up" their data processing staffs as well as those in other areas to exploit the full potential of automation.

All operating levels should be trained in EDP principles so that an institution's many divisions will better complement each other, he added.

Looking ahead to the challenges ahead in the "space-age economy," Mr. Plummer suggested banks concentrate on recruiting and training top quality personnel and insuring their retention for management succession.

Another speaker, Cooper M. Cubbedge, vice president and manager, Jacksonville Properties, discussing ways banks might reduce financial losses from damage to data processing system, stressed the importance of installing equipment in building carrying the best construction classifications.

Basement risks are always bad, he pointed out, because of possible flood and water damage, and first floor installations when not properly protected, substantially increase the vandalism hazards. The best place would be one where there are no outside windows to the EDP area he said, and which has smoke and temperature rates-of-rise detection systems.

The insurance executive also suggested banks consider storing computer tapes and records in a fire-proof vault separate from the room where the system is installed.

He also warned banks must institute good control system to insure that computer programs cannot be tampered with. "An auditor should always bear in mind that anything programmed into a machine may be patched or reprogrammed. An auditor must always remember that the machine does what it is told and if programmed or told to manipulate forms, or handle fictitious accounts, will do so without discrimination," he noted.

Charles J. Hughes, auditor, First National Bank, Miami, told the bankers an audit program protects the employees of a bank as well as its assets. "It is easy enough to be unforgiving and unmerciful when an employee has failed in a trust," Mr. Hughes said.

[From the American Banker, May 20, 1966]

TREIBER WARNS NJBA ON CD DEPENDENCE

(By Robert A. Bennett)

ATLANTIC CITY, N.J.—Bankers were cautioned Thursday not to depend too heavily on certificates of deposit for liquidity requirements. The warning came from William Treiber, first vice president, Federal Reserve Bank of New York.

He spoke at a luncheon sponsored by the Federal Reserve Banks of New York and Philadelphia on the second day of the 63rd annual convention of the New Jersey Bankers Association.

Mr. Treiber noted that while the banking system as a whole may not lose deposits from an outflow of interest-sensitive CD money, an individual bank can.

"Now is the time for each banker to scrutinize carefully his liquidity needs, his ability to maintain his deposits and his reserve needs to support his deposits," Mr. Treiber said.

But he said banks should not sacrifice liquidity to increase short-term earning power, because in the long run "it may turn out that a relatively-modest increase in earnings has been purchased at too high a cost—a cost incurred through

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adjustment later—forced upon the bank because a low cushion of liquid assets turned out to be inadequate to meet losses of interest-sensitive deposits."

Mr. Treiber also evaluated calls made earlier by other top Federal Reserve officials for a tax increase to halt inflation. Any increase, however, should be temporary, with as neutral an effect on taxpayers as possible, Mr. Treiber said.

Moreover, the increase should be large enough to "blunt inflationary pressures," but not so great as to "jeopardize continuing expansion of economic activity," he said.

The Federal Reserve official also said that a combination of a tax increase and a reduction in Federal spending "would seem helpful."

Mr. Treiber had strong praise for a speech made Wednesday by Archie Davis, president of the American Bankers Association and president, Wachovia Bank & Trust Co., Winston-Salem, N.C.

Mr. Davis urged bankers to exhibit "statesmanship and restraint" in seeking deposits and making loans. Mr. Treiber told the New Jersey bankers that while the Fed will allow the money supply to expand, enough funds will not be created to fulfill the demand of all credit-worthy customers.

Referring to Mr. Davis' speech, Mr. Treiber asked the bankers to channel available credit into the most productive sectors of the economy and to temper their efforts in seeking deposits.

In response to such pleas, the convention resolved that New Jersey bankers should exercise "such voluntary restraint as is necessary to avoid nonessential and speculative pursuits which might exhaust credit and further impair bank liquidity."

Other resolutions adopted by the convention called for New Jersey bankers to urge labor and business leaders to seek wage and price policies beneficial to the overall economy; to support reduced spending at all levels of government, except for defense, and to use their influence to prevent "unwarranted expansion of installment debt" which would drain the nation's resources from more productive channels.

[From the American Banker, May 13, 1966]

Bankers Warned To Use Caution in Promotion of CD's

(By Charles Bartling)

Cincinnati.—This is not the time for most banks to promote the sale of savings certificates aggressively, the president of the savings division of the American Bankers Association said here Thursday.

D. James Pritchard, vice president of Society National Bank of Cleveland, made the statement here in an interview before addressing the 75th annual convention of the Ohio Bankers Association.

He voiced concern over a tendency toward alarm among some bankers when a competitor raises his rates on consumer-sized certificates of deposits.

Rather than a headlong rush to meet the competitor's price without reasonable assurance the funds can be put to work profitably, a more enlightened approach might be to advertise the convenience benefits of passbook savings and at the same time quietly offer the higher-priced CDs to those savers who would otherwise transfer funds to another institution, Mr. Pritchard suggested.

Even then, he added, "we must not become unduly alarmed if the depositor goes elsewhere for a higher return, because all of us have experienced that there is very little loyalty connected with this rate-hungry money. It is very sensitive to change."

He conceded that if the economy should enter a new era of inflation, the 5½% rate on savings in retrospect, may appear to have been low. Otherwise, banks that avoid haste today may weather the high-interest period with little, if any, significant reduction in time and savings deposits.

Meanwhile, he advised, banks would be wise to concentrate their efforts on promoting facilities and services that yield a greater return. "A full-service bank has much to offer," he said in his speech. "Therefore, let us continue to promote constructively our facilities and services."

The money market is still tight, he acknowledged, and from all indications will continue to be so in the months ahead. "The only real hope for a major break in the demand pressures would be a significant tax increase and/or a major cut in government spending. However, neither seems imminent."

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He noted, nevertheless, an apparent turnaround in demand deposits, which declined 1.5% in 1965. Latest Federal Reserve figures show that demand deposits in March and April advanced at a seasonally adjusted annual rate of 14%, while in April alone, the gain had accelerated to a 17.6% rate.

If there is, in fact, a reversal, he said, one possible explanation may be that corporate treasurers are building up their own reserves in the form of demand deposits to meet capital outlay commitments.

The treasurers are reluctant to tie up their funds in CDs during a period in which it is difficult to obtain a loan. So to protect their position, they may be building a cushion of reserves in their demand deposit accounts, he added.

Mr. Pritchard's talk was delivered during the afternoon session of the one-day convention.

[From the New York Times, May 10, 1966]

DEMING CAUTIONS ON BID FOR FUNDS—AGGRESSIVE BANK BEHAVIOR IN FIGHT FOR TIME DEPOSITS ASSAILED BY U.S. AIDE—WARNING FLAG IS RAISED—SOME INSTITUTIONS ARE SEEN OVEREXTENDING AND TAKING ON EXCESSIVE RISKS

(By Edwin L. Dale Jr.)

WASHINGTON, May 9—Frederick L. Deming, Under Secretary of the Treasury for Monetary Affairs, warned today against "overly aggressive behavior on the part of some banks in competing for time deposits."

Mr. Deming raised the warning flag in a speech to the Society of American Business Writers in Minneapolis. The text was made available here.

He said the aggressive bidding for time deposits "may tend to distort the impact of monetary policy, impairing the stability of particular institutions and even of some sectors of the economy."

It could also "induce some banks to overextend themselves and take on excessive risks" in their lending, he added.

Pointing out that the "increased cost of time deposits has placed many banks under pressure to seek higher yields and more loans," Mr. Deming continued:

"Even where loans are sound, banks may get burned in their bidding for time deposits. If funds can be bid away from other institutions by a particular bank, that same bank may find itself losing deposits at a later date to a still more aggressive insitution.

POSSIBLE RESULT

"The result may be a bidding up of time rates—not because funds can be employed profitably, but because funds are needed to meet current demands or to replace funds that were bid away by other institutions. In tight financial markets even the liquidation of good assets can be painfully expensive," he said.

Mr. Deming also said that "other financial institutions may be more vulnerable than banks to a sudden loss of funds."

He warned banks paying high rates on time certificates of deposit running nine months or more into the future that "interest rates on loans can go both ways, and the commitment to pay high rates for a long period may prove to be risky and unprofitable."

A "more cautious" lending policy by banks "will not only be in the public interest but in the interest of the individual banks in question," Mr. Deming said.

He cautioned also that "when financial market pressures diminish, then time deposit rates—particularly those on savings accounts—may prove to have some downside rigidity." It may be difficult, he said, "for individual institutions to lower rates unless they have some confidence that others are similarly motivated."

Mr. Deming's warning came a day after the Federal Reserve and the Federal Deposit Insurance Corporation announced a joint survey of the "rates and terms" that commercial banks are offering to pay on time and savings deposits and on changes in the flow of savings funds.

The Federal Reserve made a similar study earlier in the year, which came to the conclusion that banks have made only "moderate" use of their present ability to pay up to 5½ percent interest on savings deposits.

In a wide-ranging speech the Under Secretary also touched on the outlook for Treasury debt management in the period ahead. He said, "We expect to get by with a minimum of cash borrowing over the next 14 months."

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Allowing for increased sales of Federal assets through "participation" and for the regular sales of securities of Federal agencies other than the Treasury, and also allowing for offsetting absorption of some Treasury securities by the Federal Reserve system and Government investment accounts, Mr. Deming said the net demand of the Federal sector on the private credit market "should be under $3-million during the present fiscal year and approach zero during fiscal 1967."

SAVINGS DEPOSITS RISE

The inflow of savings deposits that savings banks have been predicting for May—following a massive outflow in April—is apparently coming through on schedule. According to the Savings Banks Association of New York State, the 15 largest savings banks in New York City had a net deposit inflow of $6.9 million in the first five business days of May. This compares with an increase of $11,-million during the similar period of 1965, and $17.9-million in 1964.

From March 29—the first of the three grace days at the end of the first quarter when deposits could be withdrawn without loss of dividends—through the end of April, these banks had a net deposit outflow of $312-billion.

[From the American Banker, May 31, 1966]

CHICAGO BANK'S ADS HIT "RATE RACE," CD'S

(By Charles Bartling)

CHICAGO.—While many banks here are advertising the availability of a 4½% savings certificate, a $120-million South Side bank has taken quite a different tone.

Chicago City Bank and Trust Co. said in a local newspaper last week that it does not intend to enter the "rate race" and it dared savings depositors in other banks to switch their funds from passbook savings to "a gimmick certificate or the like."

Author of the all-type advertisement headlined "Bankers, Gimmicks and Discrimination" was W. Norbert Engles, president of Chicago City B&T.

The soft-spoken native Georgian declared in an interview that financial institutions are doing themselves and the economy a disservice by participating in a "rate race" on consumer certificates of deposit.

"Now I have nothing against the CD," he said, "as a money-market instrument. We offer them ourselves—but only to corporate customers who keep a good balance in their demand accounts. It's the savings certificate I don't like."

As he stated in his 2-column-by-10-inch ad, extensive advertising of the low-denomination CD has produced several adverse effects.

"It has started a rate race among both banks and savings and loan associations in defiance of official Washington warnings of caution from Secretary of the Treasury (Henry H.) Fowler on down.

"It has added fuel to the inflationary fire, both real and psychological, from which no one will benefit—except perhaps the inflation speculators.

"It has forced loan rates up for both commercial paper and home loans. Instead of trimming back new expansion, it simply has raised the cost-plus factor which will be passed on to the ultimate consumer.

"It has made the purchase and rehabilitation of homes almost impossible, for this is the first to be cut back in the lending market.

"And it has made second-class depositors of the savings customers at the banks using this gimmick. Those banks are not paying—and by regulation cannot pay—more than 4% interest on regular passbook savings accounts."

Mr. Engles advised in the ad that those savers who find themselves to be "second-class citizens" in their banks should immediately switch their funds to the "gimmick" accounts, or to move their accounts to Chicago City, where the savings passbook holders "is still a first-class citizen."

Mr. Engles does not feel that legislation is the answer to the CD problem or that the Fed should alter the present ceilings under Regulation Q.

He ran the ad, he said, in hopes that other bankers will join him in a "statesmanlike reappraisal" of the situation. The first step, however, is to stop promoting high rates. "This in itself will help cool off the war."

The techniques of running newspaper ads urging rate restraint is not altogether a new one. However, the idea of discouraging banks from advertising the high

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rates met a certain amount of resistance in newspaper advertising departments here.

At least one major daily refused to run the ad and another objected to the term "gimmick" in reference to savings certificates. The first ad ran in the Chicago Tribune May 24, and "my phone has been ringing constantly ever since," said Mr. Engles.

"Bank presidents and board chairmen from all over have called and written to give moral support. But I want to tell them: 'Don't just agree. Do something'."

In Michigan, full page ads were run by Michigan Bank NA and Michigan National Bank, with a message signed by Howard J. Stoddard, chairman of both banks.

Also, First National Bank of Lapeer, Mich., in the context of a somewhat different rate structure, has advertised that it declines to increase its interest on passbook savings and on one-year savings CDs, using much the same arguments as those advanced by Chicago City B&T.

Mrs. SULLIVAN. I would also like to call attention to the remarks of Archie Davis, the president of the American Bankers Association, when he spoke before the Arkansas Bankers Association last week, and said:

> The urgent need is for bankers to accept full responsibility now specifically by exercising restraint in the use of their competitive advantage.

He discussed specific ways in which bankers could exercise restraint in lending, and he also warned bluntly against continuation of the existing rate war. He named both savings and loan associations and smaller banks as potential victims which must be spared in order to preserve the financial structure as it now exists.

I have just one question, Mr. Chairman.

I am informed that the outstanding certificates of deposit issued by New York banks between September 29 and April 20 increased by 10 percent, but fell by 5 percent elsewhere.

Is it not likely that the top rates paid on time deposits and certificates of deposit by the money market banks are draining funds from all over the Nation to the money centers like New York, thus leaving the financial needs of people in small cities and towns unsatisfied? Hasn't that been a recurring weakness in our financial system?

Mr. MARTIN. I think there has been some tendency from time to time for shifts of this sort. But I think it is being exaggerated at the movement because of the fact that people are saving less and spending more. And we are in a major movement of funds. I have great question personally whether ceilings of one sort or another are the proper way to handle this. I think that the ceilings have gotten us into the difficulty. And if I may say so, Mrs. Sullivan, I have indicated a number of times as far as I am concerned I think we might eliminate regulation Q and have it only on a standby basis for use under emergency circumstances.

I think we would have a better flow of funds without putting these differentials in rates. But when we get into this sort of an operation, we have an obligation to think of the saver as well as the institution. The saver has been getting a better rate recently. And to see that the flow of funds is not unduly impeded by putting dams in the stream at various places by artificial means.

This is a very complicated and difficult operation, but we just make it more complicated by thinking of devices to reassert flows in different directions.

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Mrs. SULLIVAN. Thank you. My time is up. I have had calls since Friday from all over the State of Missouri from bankers expressing concern about what is going on. However, not one of them has made any suggestion about what should be done to correct this situation.

Mr. MARTIN. I can assure you I have had many calls also.

Mrs. SULLIVAN. Thank you.

The CHAIRMAN. Mr. Widnall?

Mr. WIDNALL. Thank you, Mr. Chairman.

Mr. Martin, on page 7 of your statement you criticize the rigid ceiling of 4½ percent on time deposits under $100,000 because it would be "far below rates currently available to the money market for such risk-free instruments as U.S. Government, U.S. agency obligations." I suppose you are referring to such instruments as the FNMA participation certificates. Later on this afternoon the rate will be established for tomorrow's $530 million issue of participation certificates under the recently passed Participation Sales Act. I am guessing the rate will be somewhere around 5.7 percent. Isn't this rate on such a large and closely watched issue going to have a severe impact on the currently tight credit market?

Mr. MARTIN. It will, indeed. It is another factor in it, Mr. Widnall. It demonstrates that the money market is tight.

Mr. WIDNALL. I think it is a bit unfair to attribute a great many of our troubles now to Vietnam. Wouldn't you say that one of our serious problems, too, is the fact that our imports are up and our exports are down, in which case we could very easily have a balance of payments deficit this year ranging from $2.5 billion to $2.7 billion.

Mr. MARTIN. This is a very worrying situation, and the Board is concerned with this, as you appear to be also.

Mr. WIDNALL. You just recently returned——

Mr. MARTIN. Our trade surplus is running at an annual rate of a little under $4 billion, whereas we were running at a $6 billion level some time ago. So that this is something that we are worried about, of course.

Mr. WIDNALL. You just recently returned from a trip to the other side, to Europe, and you are in touch with a lot of the international bankers over there. What is their opinion about the general credit situation in the world rate now?

Mr. MARTIN. In the world, or over here?

Mr. WIDNALL. In the world—the markets we normally deal with in Europe and in the United States.

Mr. MARTIN. I think they are watching the U.S. balance of payments with considerable interest, and that they are hopeful that we will put our balance of payments in better condition than it is.

Mr. WIDNALL. The English pound is under attack again now, is it not?

Mr. MARTIN. It is.

Mr. WIDNALL. If anything material is done by way of adjustment there, this could also have an adverse effect on our situation here in this country, could it not?

Mr. MARTIN. It could.

Mr. WIDNALL. As we approach July 1, we are sort of teetering and tottering as to what is going to take place on July 1, where we will have a showdown in many areas, with maturities coming up.

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Mr. MARTIN. The Board is very alert to these problems, and are aware of them, and we are going to do everything we can to deal with them.

Mr. WIDNALL. I find that back in my own area—although not only there—there is a tremendous worry about the effect on the construction industry that is taking place right now through lack of credit, and through a shortening of terms by material people—where they were giving 90 days they are now giving 30 days—increasing the costs of materials, many of them having gone up to 10, 15 percent.

One glaring example of increasing costs is in oak flooring. I understand in 5 months it went from 32 cents a square foot to 60 cents a square foot. It means inflation, and seriously means inflation. And I hope we are not going to act too late to meet some of these challenges.

I appreciate your being here today.

The CHAIRMAN. Mr. Reuss?

Mr. REUSS. Thank you, Mr. Chairman.

Chairman Martin, you commented a moment ago about the Reuss amendment to the Defense Production Act, with which you are familiar, which would give the President standby powers to control consumers' credit with the provision that it can be delegated either to the Federal Reserve or any other agency or agencies which he thinks best.

You stated that in your judgment standby controls over consumer credit were an effective part of the anti-inflationary arsenal.

I agree with your observation that selective controls over consumer credit should be an adjunct to sound fiscal and monetary measures rather than a substitute for them. But concentrating your mind on the so-called Reuss amendment, which will be voted on by the House next week, do you favor that standby amendment or do you oppose it?

Mr. MARTIN. I do not have the amendment in front of me.

Mr. REUSS. It has been submitted to you some time ago.

Mr. MARTIN. Let me put it this way. If we had the authority, if the President had this authority, and had delegated it to the Board, I do not believe the Board would utilize the authority at the moment.

Mr. REUSS. I understand that. And I would hope that the President would not utilize it now either. But my question, which I think can get a simple yes or no answer, is: Do you favor the amendment giving standby powers over consumer credit to the President which will be voted on next week?

Mr. MARTIN. I would prefer it going to the Board or to an agency rather than to the President. But I would not object to it in either case.

Other members of the Board might disagree with me on this.

Mr. REUSS. I realize that. And in order to secure the widest possible consensus, we left it to the President—though in speaking for myself, I would anticipate that if controls became necessary, he would refer to the Federal Reserve Board as much of the operation as the Federal Reserve Board wanted. It might be that he might want to refer part of it some place else—I don't know.

But my simple question with reference to the Reuss amendment, which will be voted on next week, is: Do you favor a yes or a no vote on that amendment?

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Mr. MARTIN. I think that all the members of the Board might have a different vote, speaking for myself, I would favor it as a standby.

Mr. REUSS. So you would recommend a yes vote on the standby?

Mr. MARTIN. I would not want it to go to the President. But since it is put in that way, I would have to give you a straight "yes" on that.

Mr. REUSS. Thank you.

Now, on the broader question, I want to commend you on your paper this morning. I certainly agree that the ultimate problem is the flow of funds. And I would like to explore with you the suggestions which I have made, that the Fed be empowered, as it is now empowered, to buy Federal Home Loan Bank securities.

If you had that power, would it not be a thing worth considering for the Fed—assuming a neutral monetary policy in the months ahead, neither expanding nor decreasing the money supply—would it not be useful for the Fed to sell, let us say, *x* amount of Treasury bills, and buy a similar amount of Federal Home Loan Bank securities? The effect of that would be to increase the interest rate a bit on Treasurys which you would be selling, which helps out in our balance of payments, under Operation Twist. It would also channel funds through the savings and loan associations to the homebuilding industry, where, according to the latest figures this week, there is an unemployment rate of something in excess of 6 percent, whereas the rest of the manufacturing economy is at close to full employment.

Would this not be a useful reallocation of the Nation's credit capacity—and with no effect of high-powered dollars, because you would be selling one high-powered instrument and buying another. What is wrong with that?

Mr. MARTIN. Well, I think it would have an effect on high-powered dollars in the long run, because you are trying to channel into a specific direction, or put pressure on the open market committee to make determinations——

Mr. REUSS. Not pressure. This is permissive.

Mr. MARTIN. No. But it would work that way, in my judgment. When you give authority to buy a given instrumentality, the pressure is going to be there to but it.

Now, I have some question about this business of selling agency issues generally. I think it costs more to the Treasury that way. And I am not sure it would not be better to sell direct obligations of the Treasury.

We don't have as good a Government securities market as I personally would like to see today, and I think this will just make the Government securities market worse.

But I want to say that we have a study going on now with the dealers in New York of all aspects of this problem. This is one of the things that we are going to take a good look at.

Mr. REUSS. Let me—because time is short—ask for a show of hands among your colleagues on the Board.

Does any member of the Board think that it would be useful if the Fed were empowered to purchase Federal Home Loan Bank obligations?

Mr. MAISEL. I think it is a far more complicated question than that. It seems to me we are dealing with about 8 or 10 different combinations here.

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One is simply the question of the efficiency of the market for agency issues. The second is the question of whether this proposal is only to improve the efficiency or also to help out when there is a glut of agency issues coming to market. There are points where you may get knots in a market because of too many issues bunching up. Here I think there may be major advantages in trying to help the situation out. In a period such as now, when we have numbers of agency obligations coming into the market, we might be better off if the Fed could warehouse these temporarily.

Another question is whether the Fed ought to be the lender of last resort to all Government agencies. I think each of those problems is involved in your question. This is what the study that the Chairman was talking about is concerned with. Would powers for the Fed to operate in agency issues really improve the efficiency of the total market for Government and agency securities? Could we narrow the spread between Government and agency issues and at what cost?

There is another matter that ought to be looked at. It seems to me that Congress, in the past, has attempted to make certain of the agencies semiprivate institutions. Some private individuals may profit from better rates in these quasi-Government institutions.

This is a legislative matter. Does Congress now want to change the thrust of what it has done in the past? Does it want to make the agencies more dependent upon Government financing than they have been? Does it want to subsidize the agencies' interest rates more directly than they have been, given the fact that the stock in some of them, in FNMA specifically but to some extent in the Federal Home Loan Bank Board, was sold to private individuals and private firms rather than to the Government. It seems to me if the object of your proposal is primarily to subsidize the agencies, then Congress would be better off voting the subsidies directly. Appropriations through the Treasury, as they did with the participation issues, should be voted so that you would know exactly what the amount of the subsidy is.

If the object is primarily to make this a better operating market—with a narrower spread—then this is what we are looking into. The questions are: Do we have the legislative authority to act? Can we make this market run as well as the Government market does? What is the relative cost in efficiency from actions taken in the agency market as opposed to action taken in the Government security market?

Mr. Reuss. My object was neither one of those, but rather a permitting of the Federal Reserve to channel credit into the homebuilding industry, which is now suffering from unemployment, and where additional output could be produced without inflationary consequences.

It seems to me we have skewed and diverted things so that the banks have all the money for making the inflationary inventory loans, and the savings and loans, which are in the homebuilding mortgage specialty, have run out of money. This concerns me.

Mr. Maisel. Your proposal does not appear to increase the authority of the Home Loan Bank to issue debentures. It seems to assume that by some sort of action there can be a slightly lower rate on the agency issues. Part of this lower rate will be at the expense of the rates paid by the U.S. Treasury.

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It seems to me if this is the object, since you are not increasing the amount of agency issues——

Mr. REUSS. I would do that, too.

Mr. MAISEL. That would be an entirely different matter. But then again it seems to me that before authorizing the Federal Government to act, Congress ought to look into the relationship of the whole home loan bank system to the Federal Government. Is it a real agency of the Federal Government? Given the fact that it is a semi-independent agency of the Federal Government, who gains from changes in the interest rates paid by the Home Loan Bank Board? Will this proposal make a difference in terms of the lending rates and availability of funds to savings and loans?

In terms of the general idea, that the Government as a whole ought to make more funds available to the savings and loans, I certainly agree with you. But I think there are major questions as to whether this is a particularly efficient way of doing it or not.

Mr. REUSS. My time has expired.

The CHAIRMAN. Mr. Gonzalez. We have enough time for Mr. Gonzalez.

Mr. GONZALEZ. I would like to obtain a comment from the Chairman on excerpts from the February 1966 issue of Banking to this effect. An article there states, and I quote:

> The Fed was aware in 1961 that the issuance of negotiable CD's of large denominations attracting funds which otherwise would be invested in readily marketable Treasury bills or prime commercial paper might influence the terms and conditions under which short-term United States Government securities are bought and sold.

Would you have any comment on that quote, Mr. Chairman?

Mr. MARTIN. I think we are aware of the problem, Mr. Gonzalez. The implications of this are something that we are studying all the time. On the whole, we think that the negotiable CD's have performed a very valuable function as an instrument in the money market.

Mr. GONZALEZ. Yes. I saw that on page 2, where you said it was a beneficial factor to good financial—strengthening the economic resources and so forth.

However, in your testimony to the Joint Economic Committee, in its hearings on December 14, 1965, the role of CD's and credit expansion—you seemed to conclude there more than anything else negotiable CD's have displaced Treasury bills in liquid corporate portfolios, which in turn, would it not, have an effect on such things as interest rates on short-term securities and so forth?

Mr. MARTIN. Mr. Daane would you like to comment on that?

Mr. DAANE. Could I make just a comment on this, since I was actually at the Treasury, and assisting on the debt management side, when the CD's began to be developed, and to grow? And in fact, this did have a rate relationship that was helpful in terms of what Mr. Reuss has referred to as Operation Twist.

It helped to keep up the shorter rate on Treasury securities for balance-of-payments purposes, and at the same time it helped to channel funds into the longer term sector of the total market, specifically into home building, and helped to stabilize or keep relatively stable our longer term rates. So I think it did have a consequence for rates. But the consequence, again, was beneficial from the standpoint of the econ-

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omy and from the standpoint of Government policy with respect to the balance of payments.

Mr. GONZALEZ. Was that a twist or a veronica?

Mr. DAANE. I pass.

Mr. GONZALEZ. Actually, though, there wasn't any purchasing of your 20-year paper, but your shorter maturities. And this is what has channeled—the CD practice has channeled into the short-term paper more than anything else. And am I right or wrong in concluding that the banks actually paid less interest on this short-term paper than they would otherwise?

Mr. DAANE. Well, the banks used the CD instrument to obtain funds which in my own judgment were used, in part at least, to go into the longer term sector of the economy and, as I say, specifically into homebuilding.

So they were in effect borrowing at rates that were attractive to the investor in shorter form, and they were channeling these funds into the longer term uses. And, on balance, I think what resulted as far as the Treasury securities market was concerned—and in the mortgage market, too, for that matter—was that it had an effect of increasing or raising somewhat the rate level of short-term Treasury securities, and holding down longer term rates. And, specifically, I think it was a factor in the decline in mortgage rates.

Mr. GONZALEZ. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. I would like to ask you one question, Mr. Martin.

Over $4 billion in large negotiable CD's mature in the month of June alone. If the large-market banks experience difficulty in renewing these CD's, do you rule out the possibility that the Federal Reserve Board may yet increase the regulation Q ceiling?

Mr. MARTIN. I could not make any commitment for the Federal Reserve Board, Mr. Chairman.

The CHAIRMAN. Beg pardon?

Mr. MARTIN. I could not make any commitment for the Federal Reserve Board.

The CHAIRMAN. What is your personal feeling about it?

Mr. MARTIN. I would hope that we would not have to raise the ceiling. But I would not rule it out.

The CHAIRMAN. You would not rule it out?

Mr. MARTIN. No.

The CHAIRMAN. It will soon be 11 o'clock. Mr. Martin, if you cannot be here, I assume the others will be here—Governor Robertson—he did a good job for you before.

Mr. MIZE. I ask unanimous consent to correct the statement that I made yesterday regarding the interest rate being paid on CD's by banks in my district. I said they were paying only 4½ percent. I read my last night's newspaper. In my own hometown, it is now 5 percent, and on checking further I find many banks are going to 5 percent, also.

The CHAIRMAN. Without objection, so ordered.

We will stand in recess until 9 o'clock in the morning, at which time the Board will be back.

(Whereupon, at 11 a.m., the committee was adjourned to reconvene at 9 a.m., Thursday, June 9, 1966.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, JUNE 9, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 9:03 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Ashley, Moorhead, Stephens, St Germain, Gonzalez, Weltner, Hanna, Grabowski, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Widnall, Fino, Mrs. Dwyer, Halpern, Harvey, Brock, Johnson, Stanton, and Mize.

STATEMENT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; PRESENTED BY J. L. ROBERTSON, VICE CHAIRMAN; CHARLES N. SHEPARDSON, MEMBER, GEORGE W. MITCHELL, MEMBER, J. DEWEY DAANE, MEMBER, AND SHERMAN J. MAISEL, MEMBER—Resumed

The Chairman. The committee will please come to order.

Yesterday, gentlemen, the testimony was very interesting to me and I want to check, Governor Robertson, a statement that Mr. Martin made as was reported in the press rather accurately in this way:

> Mr. Martin acknowledged in his testimony that the savings and loan associations have been placed at a competitive disadvantage and that the associations' loss of savers' funds in turn has led to an "unusual tightness" in the home mortgage market. "We believe the Congress would be fully justified in taking sharp action to provide a cushion against too sharp a cutback in residential construction," resulting from the saving and loan associations' problems in attracting funds, he said.

Is that your understanding of his statement, too?

Mr. Robertson. My understanding was that he said, in effect, that this problem should be dealt with selectively by Congress in providing more funds directly into this market in order to prevent too big a bite in the housing area.

The Chairman. Another statement he made I wanted to check:

> Mr. Martin argued strongly against fixing ceilings on interest rates by law. "The Board believes that the determination of ceiling rates and differentials in rates should be left to administrative discretion, thereby permitting adaptation of the ceilings to changing circumstances."

Mr. Robertson. I think that is exactly what he said.

The Chairman. That leads to the question, then: Would you leave ceilings on interest rates to administrative boards, would you leave

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that up to the 50 States? Which way would you feel would be the proper way to do it? That the National Legislature should not fix interest rates at all, that we should leave it to an administrative board like the Federal Reserve? Would you make that statement—that it should be left to the administrative boards and not to State legislatures?

Mr. ROBERTSON. I think that as a general proposition the principle would be as applicable to a State government as it would be to the Federal Government.

The CHAIRMAN. You think the same rule should apply?

Mr. ROBERTSON. Yes; I would think the same rule should apply. Now, I would want to differentiate between usury statutes, for example——

The CHAIRMAN. That is right.

Mr. ROBERTSON. And the kind we are talking about here.

The CHAIRMAN. I understand.

That being true, I wonder about some of these things, about how we are going to handle them. I wonder if you would object to permitting a change in these rates, if we were to fix the rate at 4½ percent and if we were successful in getting it enacted into law. You would want, of course, flexible action, if left up to the Federal Reserve Board.

Suppose we were to write in there the provision that the rates would be changed, if approved by the President of the United States, would you approve that?

Mr. ROBERTSON. I would think this would not be in accordance with the testimony which we have given; namely, that——

The CHAIRMAN. The President, you know, is elected by the people——

Mr. ROBERTSON. I understand——

The CHAIRMAN. That is the only chance the people have at getting back at somebody. Now, they cannot get back at you. You have a 14-year term and you cannot be reappointed. So that is it, as far as you are concerned. You can do anything you want to and there is no way of reaching you. People cannot reach you, but this other way they can reach the President and you would not oppose the President approving these things, would you?

Mr. ROBERTSON. I would never, of course, oppose the President fixing these, but I do think there is a real problem investing this power in the President because——

The CHAIRMAN. I said "invested in you."

Mr. ROBERTSON. With a veto power. This places upon the President a very difficult job, it seems to me, because nobody ever wants tight money.

The CHAIRMAN. Do not look at it from the President's point of view. Look at it from the peoples' point of view—the public interest.

Mr. ROBERTSON. I can understand that. I was trying to think solely in terms of pressure that might be brought.

The CHAIRMAN. Now, yesterday we had not finished—

We had gotten to Mr. Gonzalez and Mr. Ottinger is next.

Mr. OTTINGER. Thank you, Mr. Chairman.

I must say that the testimony that we received on this subject shows that it is complicated in its implications and they are far reaching. I think we are all concerned to reach a sound result—a result that will correct the inequities.

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When you testified the last time you indicated that if the Board were given the power to differentiate with respect to interest rates, with respect to denominations——

Mr. ROBERTSON. Size, you mean?

Mr. OTTINGER. Yes—that you would not use such authority if granted. In light of what has transpired since then, do you now have any different view on that?

Mr. ROBERTSON. No. I have no different view. I would be very reluctant to discriminate between the large and small deposits. I would be very reluctant to have the Government say to a bank, you can pay a higher rate of interest to the man with lots of money but not to the man with a very small amount of money. This is a matter in which other people may vary in their views and the Board might very well use this on occasion as a temporary expedient to cope with a particular problem.

Mr. OTTINGER. You do not go along with Mr. Martin's feeling that there are really different markets involved, that the larger denomination of CD's is a repository for large corporate funds and really constitutes a separate market?

Mr. ROBERTSON. I agree with the fact. That is a fact, there are different markets. But I have great difficulty in accepting that as a justification for Government saying to banks, "You can pay in one market more than you can in another one." This is a very difficult problem.

Mr. OTTINGER. How do you justify the continuation of a 4-percent limit on passbook savings, then?

Mr. ROBERTSON. I think it is very unfortunate. From my point of view, a mistake was made in 1964 when the savings deposits were left down at a low rate and others were moved up above it. I cannot see any justification for Government telling banks that on a savings deposit they can pay one rate, but if it is turned into a time deposit they can pay a higher rate, because there is no difference whatsoever between the very short term kind of deposit—the 30-day deposit, for example, where you can renew it automatically—and the savings deposit. So I think this is one of the mistakes that has been made in the past and I personally would not go along with it.

Mr. OTTINGER. Along with that comparison, your 30-day term deposit comes very close to a demand deposit. Do you think the reserve requirements for time deposits ought to be equated with that for demand deposits on the same theory?

Mr. ROBERTSON. I think the closer you come down to a demand deposit, the more difficult you make the administration of the laws which were designed to separate the treatment of demand deposits and time deposits. Consequently, from my point of view, we should go back to what the Federal Reserve did for many, many years; namely, relate the rates to the maturity of the obligations. This would mean that you would stretch them out and make a bigger gap beween demand deposits and time deposits.

Mr. OTTINGER. Do you have authority to increase reserve requirements with respect to short-term time deposits?

Mr. ROBERTSON. Not with respect to short term, but with respect to time deposits, we have the power.

Mr. OTTINGER. You have no power to differentiate?

Mr. ROBERTSON. We could raise reserve requirements from 4 to 6 percent on time deposits other than savings deposits, but keep the

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present 4-percent requirement on savings deposits and on the first $5 million of other time deposits in order to protect the small bank. We have that power.

Mr. OTTINGER. Would your inclination be to exercise that power?

Mr. ROBERTSON. I would say this is a matter which the Board itself must make a determination on. I do not think we ought to have a rundown here. But I personally happen to favor this.

Mr. MITCHELL. I would like to say something on this point generally. We should not overlook the fact that passbook savings are only for individuals and corporations cannot make deposits under the passbook arrangement. So this may be a basis for distinguishing between the passbook rate and the CD or the open book account rate.

Now, passbook savings also have another advantage, as a matter of practice, they are withdrawable on demand and as far as certificates of deposit are concerned, these are fixed maturities and they may be long and they may be short. They are fixed in a negotiation between the bank and the customer. But in every instance, the bank knows exactly when that is coming due and it must be prepared either to renew it, get some other funds, or liquidate some of its assets.

Mr. OTTINGER. Individuals are investing very heavily in these CD's in the Midwest. The distinction has certainly become much less significant in recent years.

Mr. MITCHELL. It is true that some individuals are attracted out of passbook savings. In fact, in the Seventh Federal Reserve District passbook savings declined a half billion dollars. But much of this was simply transferred to CD's held by individuals so a net decline in time and savings accounts combined did not take place. There is a significant difference between the CD and the passbook savings; passbook savings are responsive to a larger degree to peoples' liquidity desires; CD's can be made more responsive to rate competition. Those people who do not need the liquidity of a passbook account can be more readily attracted into CD's.

Mr. OTTINGER. When you get down to the 30-day CD, that is pretty academic.

Mr. ROBERTSON. It amounts, in my opinion, to the fact that the unsophisticated saver gets 4 percent and the sophisticated saver gets what they can negotiate.

Mr. OTTINGER. The small fellow is being taken advantage of, who, through ignorance, happens to keep his savings in passbook accounts or U.S. savings bonds.

Mr. MAISEL. The point that you made earlier about separate markets made a great deal of sense. We have to differentiate among the markets for funds. The concept of free markets and the use of supply and demand says that one cannot look only at one side. In addition to where the money is going, the amount paid has to be concerned with the competition to raise money. The question which the Board and which Congress faces is: Do you want to differentiate rates based upon the separate markets within which these moneys have to be raised? Should the amount paid vary with the competition in the different markets? It seems to me that, given our belief in a free-enterprise economy, this makes sense. We should be willing to differentiate on a market basis. Therefore, I feel it would be proper for Congress to pass a law which in effect recognizes that we now

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have three separate markets; the passbook savings market, the market for deposits under $100,000, and the market for over $100,000 certificates. It seems to me that this is a logical basis on which to differentiate. Each of these markets might then have a separate reserve ratio and a different ceiling on authorized interest rates.

I believe these two factors should be joined. If you are going to separate the three different markets, you ought to allow each both a unique ceiling rate and a separate reserve ratio.

Mr. OTTINGER. Thank you very much. My time has expired.

The CHAIRMAN. Mr. McGrath?

Mr. DAANE. Could I make a comment? I would like to reiterate what Chairman Martin said yesterday, that I think that legislative authority for the Board to distinguish temporarily under certain circumstances by size might prove a very useful adjunct to the authority which we now have to distinguish by maturities.

The CHAIRMAN. All right. Mr. McGrath?

Mr. MCGRATH. Thank you, Mr. Chairman.

Governor, can you tell the committee when the New York banks first began to pay interest on time deposits of corporations?

Mr. ROBERTSON. Well, the large negotiable CD really came into the picture in 1961 as a money-market instrument, although banks have been issuing them for years and years and years.

(The following article was subsequently submitted by Mr. McGrath:)

[From the New York Times, Feb. 21, 1961]

FIRST NATIONAL CITY BANK PAYING INTEREST ON ITS TIME DEPOSITS

(By Albert L. Kraus)

The First National City Bank of New York began paying interest on time deposits to its larger corporate customers yesterday. The Chase Manhattan Bank and the Morgan Guaranty Trust Company of New York indicated they would follow suit.

First National City began selling interest-bearing certificates of deposit to corporations with $1,000,000 or more to invest. These will be marketable but not redeemable before maturity, with interest rates, maturities and the amounts outstanding varying from time to time.

Alan H. Temple, vice chairman, said the move was being made to permit the bank to compete for deposits lost in recent years to Treasury bills and other open market securities. Since the early Nineteen Thirties, New York City banks have not paid interest on time deposits of domestic corporations. Banks in other cities have, however. Banks are forbidden by law from paying interest on demand deposits.

Demand deposits, as their name suggests, are payable on demand. Regular and special checking accounts are the most common form of demand deposits. Time deposits may not be withdrawn for a specified period of time, usually three months or six months.

Under the Federal Board's Regulation Q, last changed on Jan. 1, 1957, commercial banks may pay no more than 1 percent interest on time deposits of less than ninety days, 2½ percent on those of ninety days to six months, and 3 percent on those of six months or more.

It was understood that the certificates were being offered initially at the Regulation Q ceiling rates. By way of comparison, ninety-one day Treasury bills were auctioned yesterday at 2.49 percent discount, which is equivalent roughly to a yield of 2.54 percent.

Government securities dealers expressed interest in the new certificates. One, the Discount Corporation of New York, said it would make a market in them if expected demand developed.

Payment of interest on corporate time deposits by the New York banks results from the large and growing competition these institutions have experienced for

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the idle funds of the biggest customers. In past years, as these funds were accumulated to pay taxes, buy equipment or pay for new construction, the corporations would allow them to remain in the banks as demand deposits. But as interest rates have risen, the pressure has grown on corporate treasurers to put these funds to work at interest.

As a result, the corporations have pared their demand deposits and increased their investments in Treasury bills, acceptances, and commercial and finance paper. New York banks doing business chiefly with large corporations, the so-called "wholesale" banks, have sustained deposit declines. Those doing business additionally with small savers and borrowers have shown less growth than banks elsewhere in the country.

While payment of interest on corporate time deposits will increase bank expenses, it also will free reserves for the creation of new earning assets. That is because the New York banks must immobilize cash equal to 16½ percent of demand deposits with the Federal Reserve while time deposits required cash reserves of only 5 percent.

Mr. McGRATH. Would it help the situation any if CD's were limited to 3 months duration?

Mr. ROBERTSON. In my view, the expansion of the gap between demand and time deposits is a very desirable thing, and we have made a mistake, I think, in taking off the former very low ceiling on deposits of less than 90 days. But this is a matter of judgment. Many institutions are using less-than-90-day CD's. To legislatively prohibit anything less than 90 days might have broad effects.

I think this is a matter which would be better left to the judgment of the people who are working in the field all the time, to make the determination; that they should have, as they do have, the power to change the rates on those maturities in order to make them less attractive.

Mr. McGRATH. I wonder if the Board is satisfied with the speed with which it, and other bank regulatory agencies, collect information on which to form an opinion on all these important financial things?

Mr. ROBERTSON. We are never satisfied with the speed with which we can get information, but I must say that the speed is accelerating with automation. But you know, we are never satisfied with it. We get it as fast as we can and we do everything to expedite the collection of data. Of course, we are not satisfied.

Mr. McGRATH. Sitting here, listening to all the witnesses that we have had on this topic, I sometimes get uneasy—I sometimes get an uneasy feeling that the people who are making the decisions are not receiving the benefit of all the information that might be available. Statistics——

Mr. ROBERTSON. Let me ask Mr. Mitchell.

Mr. MITCHELL. I would like to place in the record this document which is called "Liquid Asset Flows." It originates in the Federal Reserve Bank in Chicago and it shows the flows of savings into savings and loan associations and banks for 31 metropolitan areas in that district. These data are compiled every month. This document shows, for example, that in April the flows into banks were $600 million, compared to $1.1 billion in March; and in savings and loan associations they were $400 million, compared to $700 million in the previous month.

They also show that in half of the metropolitan areas—16 out of 33—there were outflows in the case of commercial banks. In 8 of these 16 areas, the savings and loan associations had inflows.

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In other words, the trends here are mixed, depending on the region that you are talking about.

The purpose of putting this in the record is to show that we do have some firm information on what is happening in the competition between banks and savings and loan associations and it is not all in one direction. It is mixed. This is the difficulty, the basic difficulty, of the problem.

Mr. McGRATH. The information that you are putting in the record deals with the month of April?

Mr. MITCHELL. Well——

Mr. McGRATH. This is June 9.

Mr. MITCHELL. The release date on this is June 3.

Mr. McGRATH. We are sitting here today and we have a space vehicle up on the moon giving us information about what is happening there, practically instantaneous and sometimes I think there is a serious time lag in the information that people who are charged with the responsibility of making decisions receive.

I, for one, am interested in seeing that the Federal Reserve Board and the FDIC and the Treasury have enough resources and equipment and people to get this information.

Mr. ROBERTSON. Could I just say that we are extremely interested in this particular feature and we have taken steps to expedite even at a faster rate the development of the kind of automation that would enable us to get information more quickly.

We have a lag between the information and the time you have to make a decision. It is much less now than it used to be, but it is still a matter of concern.

Mr. McGRATH. I am glad to hear that.

(The documents referred to follow:)

LIQUID ASSET FLOWS

In April, both commercial banks and savings and loan associations in the District's urban areas continued to experience a falling off in net savings inflow (on a seasonally adjusted basis). For the banks, April's inflow came to $0.6 billion (annual rate). This was only half as large as the $1.1 billion added in March. Similarly, savings and loan associations reported net savings inflow, seasonally adjusted, of $0.4 billion in April, compared with $0.7 billion in the preceding month.

Withdrawals from personal time accounts (savings deposits and individually held CD's) at commercial banks were greater than new additions in 16 of the District's 33 metropolitan areas, resulting in a net outflow of funds. In virtually all of the 16 areas, the deposit outflow this April contrasted with a net inflow or a smaller outflow in April 1965. In 8 areas—Champaign-Urbana, Peoria, Rockford, Springfield, Muncie, Cedar Rapids, Sioux City and Kalamazoo—bank saving was down, but savings and loan share saving was up.

Outflows from savings and loan associations occurred in fewer areas than was the case with bank savings—the number of areas with net reductions in share saving was 12 out of the 33. In places like Chicago, Fort Wayne and Ann Arbor, savings volume was down at both institutions. Sizable outflows at savings and loan associations accompanying unusually large inflows at banks, suggesting shifts induced by attractive rates of interest paid on bank savings, showed up in only a few areas—namely, Indianapolis, South Bend, Lansing and Saginaw—all within Indiana and Michigan. The contrast is striking in some. In Indianapolis, for example, commercial banks indicated savings additions in April of $4.6 million, against a $747 thousand loss in the 1965 month. Net savings *outflow* at savings and loan associations in the area this April came to $4.3 million, whereas last April a net addition of $1.6 million had been reported.

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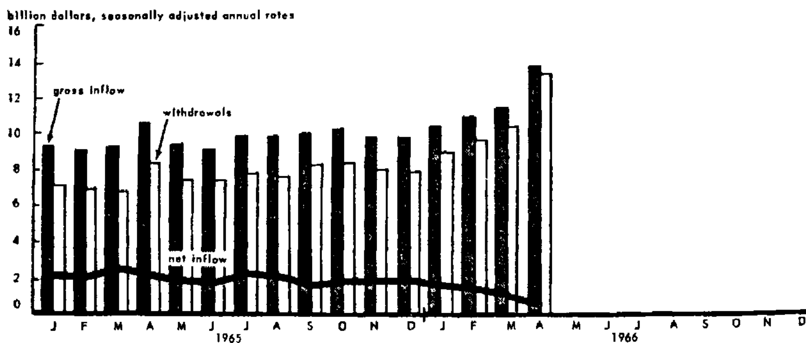
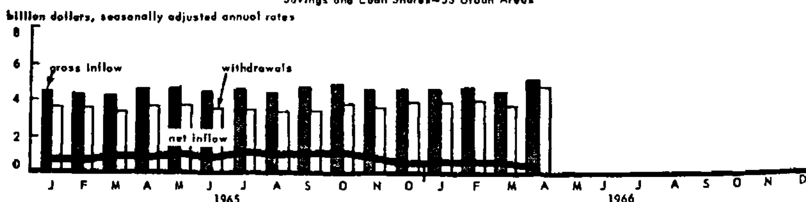
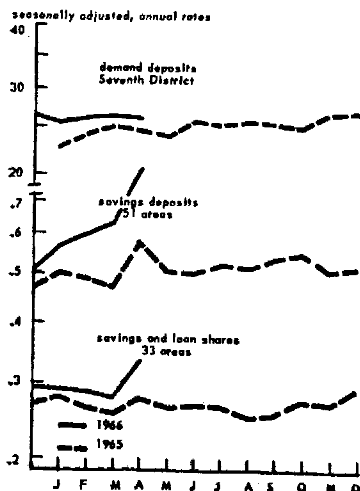
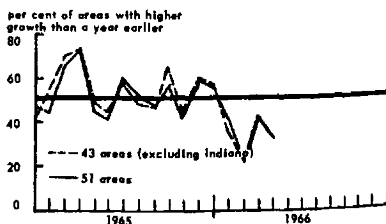
Another tabulation suggesting that effects on savings and loan share savings of recent bank competition have been extremely mixed within the District is that the ratio of bank savings balances to savings and loan share capital was higher in April than in March in 9 of the 33 areas, the same in 14 areas and lower in 10.

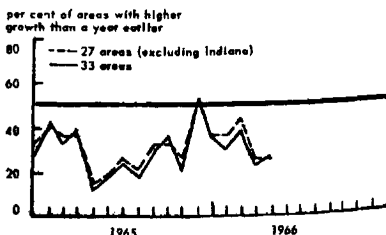
PERSONAL SECTOR











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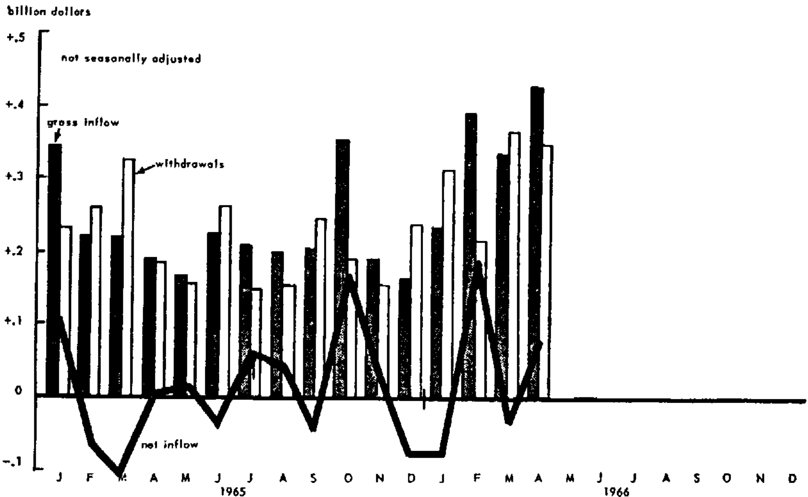

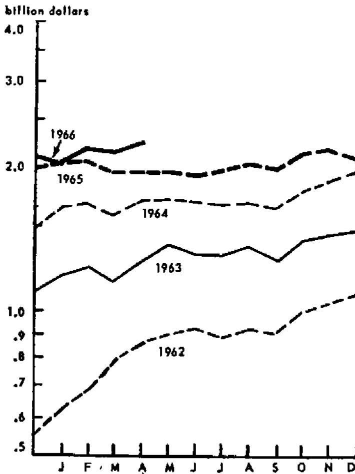

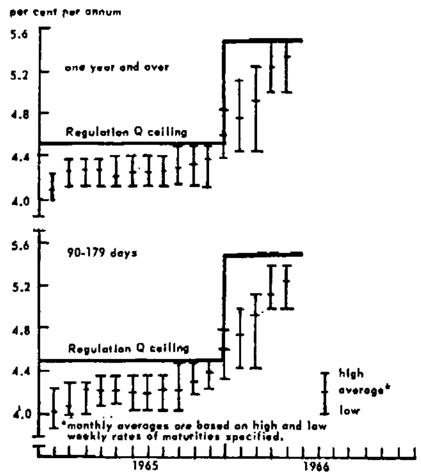

ACTIVITY IN TIME DEPOSITS

Decreases in total time deposits of individuals and business were reported during April by commercial banks in an unusually large number of the District's 51 urban centers. Banks in 18 of these areas showed time deposit decreases, in contrast to the four areas which had decreases in March. The number with decreases was more than in any month since November 1964. For all centers

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combined, growth of 0.6 percent this April compares with a rise of 0.8 percent in the year-earlier month.

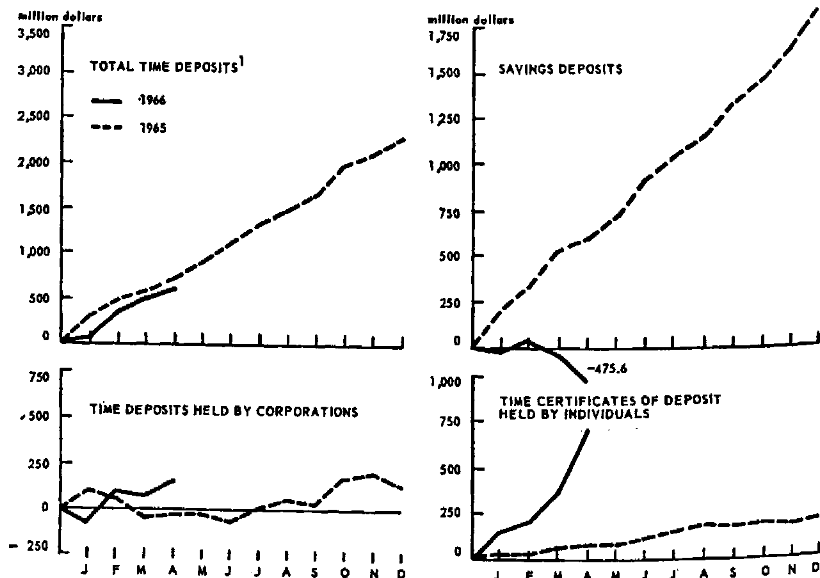
To a large extent decreases in total time deposits reflected sizable net outflows from personal accounts. Passbook savings deposits fell 430 million dollars or 3 percent in April. Although individually held time certificates of deposit rose 345 million dollars or 18 percent, a decrease was nevertheless registered in the sum of the two. The deposit decline of 0.6 percent compares with an 0.7 percent increase in April a year ago. One partial explanation for the deposit decreases at certain banks may be the payout of interest on time certificates, the transfer of interest to customers' checking accounts, at regular three-month intervals prior to maturity; whereas last year the funds were in passbook accounts so that the quarterly interest credits showed up in passbook savings.

Outstanding corporate CDs at the District banks rose 79 million dollars (3.7 percent) during the month. This was more than last April's gain of 0.1 percent. The showing of corporate deposits in many areas was much better than in personal accounts. In the Illinois areas, for example, while personal deposits were down 0.6 percent, corporate deposits were up 4.0 percent. In Indiana, Iowa and Wisconsin pluses were recorded for both groups but those for corporate deposits were greater than for personal deposits. The only exceptions were in the Michigan areas.

In April (as it was in March) it is evident that open account time deposits in some areas were responsible for the falling off in other forms of time deposits. In Lafayette, Muncie and Detroit, for instance, total time deposits increased despite decreases in the personal savings-type and corporate categories.

TIME DEPOSITS AT COMMERCIAL BANKS IN 51 SEVENTH DISTRICT URBAN AREAS

(*cumulative change since year end*)



[1] Includes savings deposits, time certificates of deposit and open-account time deposits held by individuals, partnerships and corporations.

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Time deposits—balances at commercial banks, selected areas, 7th Federal Reserve district

Area	Percent change from previous month			Percent change from year-ago month		
	Total time deposits IPC [1]	Personal savings-type deposits [2]	Corporate deposits [3]	Total time deposits IPC [1]	Personal savings-type deposits [2]	Corporate deposits [3]
Illinois:						
Bloomington	+0.1	+0.2	−32.5	+10.0	+9.3	(4)
Champaign-Urbana	−0.4	−0.6	+0.9	+16.3	+20.7	−42.6
Chicago	+0.6	−0.7	+4.0	+9.9	+7.1	+22.4
Danville	+1.8	+1.4	+4.4	+27.6	+21.9	(4)
Decatur	−0.6	+0.5	−24.9	+7.7	+16.8	−65.1
Peoria	−0.8	−0.8	+3.1	+11.0	+13.4	−22.6
Quad Cities [5]	+0.2	+0.1	+3.4	+8.4	+8.4	+9.4
Rockford	−0.1	−0.5	+4.5	+11.1	+9.5	+35.5
Springfield	−0.1	−0.3	+13.0	+9.5	+11.3	−10.9
Total, excluding Chicago [5]	−0.1	−0.2	+1.7	+10.8	+11.9	−9.5
Total, urban areas [5]	+0.5	−0.6	+4.0	+10.0	+7.7	+21.6
Indiana:						
Anderson	+0.8	+0.6	+1.6	+24.8	+23.1	+86.2
Fort Wayne	−0.3	−1.2	+6.9	+19.6	+17.9	+41.7
Gary-Hammond	+0.4	−0.6	+0.8	+17.5	+10.9	+20.8
Indianapolis	+2.4	+1.1	+8.1	+27.2	+19.5	+24.8
Lafayette	−0.3	−0.1	−8.9	+17.5	+18.2	+16.4
Muncie	+1.7	−0.1	−3.6	+14.1	+13.0	−17.2
South Bend [5]	+0.4	+0.2	−3.0	+21.9	+20.7	−8.9
Terre Haute	+0.4	+0.2		+11.0	+11.1	
Total, excluding Indianapolis [5]	+0.3	−0.3	+0.8	+18.6	+16.1	+14.7
Total, urban areas [5]	+1.1	+0.1	+5.8	+21.8	+17.2	+21.6
Iowa:						
Burlington	−0.3	−0.3	−2.9	+11.6	+11.0	+23.1
Cedar Rapids	+0.4	−0.3	+15.9	+16.5	+15.4	+51.0
Clinton		−0.1	−2.9	+4.2	+4.1	+27.5
Council Bluffs	−0.1	+0.8	−11.8	+14.6	+19.9	−29.0
Des Moines	+1.2	+1.2	+0.9	+19.0	+16.2	+81.5
Dubuque [5]	+2.8	+1.8	+6.7	+10.2	+6.6	+25.8
Marshalltown	+0.9	+0.9		+23.6	+25.9	−34.6
Mason City	−0.6		−15.5	+10.8	+13.7	−31.0
Muscatine	+3.2	+3.2		+15.4	+15.8	+1.4
Ottumwa	+2.7	+2.8	+0.4	+23.4	+28.4	−42.1
Sioux City	−0.1	−0.2	+4.6	+5.8	+6.3	−8.7
Waterloo	+2.1	+2.6	+0.1	+16.9	+17.8	+13.7
Total, excluding Des Moines [5]	+1.0	+0.8	+2.7	+13.0	+13.4	+8.8
Total, urban areas [5]	+1.0	+0.9	+2.2	+14.5	+14.1	+22.7
Michigan:						
Adrian	−1.2	−1.4		+20.1	+20.2	+24.4
Ann Arbor	−1.2	−1.5	+16.3	+19.1	+19.1	+25.2
Bay City	+0.2	+0.5	−11.7	+7.7	+12.7	−61.0
Detroit	+0.7	−1.3	−1.2	+15.8	+13.1	−5.1
Flint	−0.9	−0.7	−13.1	+14.0	+14.9	−30.4
Grand Rapids	−0.6	−0.6	−1.7	+10.8	+11.4	−2.4
Jackson	+0.4	+0.3	−10.5	+8.6	+6.6	+59.5
Kalamazoo	−1.4	−1.1	−1.9	+26.7	+30.5	−21.2
Lansing	−1.0	−1.8	+26.6	+11.1	+12.6	−25.1
Muskegon	−0.4	−0.3	−10.0	+12.0	+13.2	−21.3
Port Huron	+0.9	+1.2	−1.7	+15.0	+12.3	+47.8
Saginaw	+0.8	+0.2	+11.8	+11.3	+11.4	+8.6
Total, excluding Detroit [5]	−0.5	−0.6	+1.5	+13.4	+14.1	−9.9
Total, urban areas [5]	+0.3	−0.1	−0.7	+15.0	+13.4	−6.1
Wisconsin:						
Appleton	+0.1	−1.0	+6.3	+15.7	+10.7	+49.8
Green Bay	+2.1	+1.6	+7.3	+11.1	+10.8	+16.0
Kenosha	+1.1	+0.8	+2.4	+4.8	+5.0	−10.7
Madison	+0.8	+0.7	+1.3	+22.3	+22.5	+16.2
Manitowoc	+0.4	+0.4		+6.9	+7.0	
Milwaukee	+1.7	+0.5	+13.5	+9.0	+10.2	−0.8
Oshkosh	+0.3	−0.1	+16.2	+13.6	+14.5	−21.9
Racine	+0.5	+0.2	+1.8	+11.8	+11.2	+49.3
Sheboygan	−0.4	+0.1	−9.7	+5.8	+6.3	−2.7
Total, excluding Milwaukee	+0.7	+0.5	+3.2	+12.3	+11.7	+22.6
Total, urban areas	+1.3	+0.5	+10.5	+10.2	+10.8	+4.7
7th district, 51 urban areas [6]	+0.6	−0.6	+3.7	+12.6	+10.8	+15.8
Rural areas:						
Illinois [5]	+0.6	+0.6	+2.5	+14.3	+16.4	−79.5
Indiana	+0.4	+0.3	+1.2	+17.7	+17.9	−14.8
Iowa	+0.5	+0.6		+21.6	+21.7	−16.0

See footnotes at end of table.

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Time deposits—balances at commercial banks, selected areas, 7th Federal Reserve district—Continued

Area	Percent change from previous month			Percent change from year-ago month		
	Total time eposits IPC [1]	Personal savings-type deposits [2]	Corporate deposits [3]	Total time deposits IPC [1]	Personal savings-type deposits [2]	Corporate deposits [3]
Rural areas—Continued						
Michigan	+2.7	−3.0	+16.2	+2.8	+2.6	+24.6
Wisconsin	+0.9	+0.9	−0.3	+10.4	+9.9	+33.2
Total	−0.1	+0.2	+3.0	+11.7	+12.3	−29.0

[1] Total time deposits of individuals, partnerships and corporations. Includes, in addition to personal savings-type deposit and corporate deposits, Christmas club and other open account deposits of individuals.
[2] Includes savings deposits and individuals, holdings of time certificates of deposit.
[3] Time certificates of deposit and open-account deposits of corporations.
[4] Percent change not computed due to unusually small year-ago base figure.
[5] Includes adjacent communities in neighboring State.
[6] Includes Battle Creek for which figures are not published separately.

Personal savings-type deposits [1]—commercial banks, selected areas, 7th Federal Reserve district

[Per $100 of average balances]

Area	1966		1965	
	Inflow	Withdrawals	Inflow [3]	Withdrawals
Illinois:				
Bloomington	$3.64	$3.40	$3.10	$3.77
Champaign-Urbana	3.74	4.35	4.47	3.28
Chicago	6.55	7.22	5.63	4.69
Danville	4.33	2.94	4.38	2.86
Decatur	11.18	10.65	6.73	4.23
Peoria	5.82	6.66	6.31	6.29
Quad Cities [4]	5.20	5.13	3.66	3.75
Rockford	3.69	4.22	4.30	3.76
Springfield	6.26	6.60	3.70	3.29
Total, excluding Chicago [4]	5.52	5.72	4.53	4.13
Total, urban areas [4]	6.43	7.04	5.51	4.63
Indiana:				
Anderson	4.84	4.20	4.83	5.89
Fort Wayne	8.02	9.17	6.83	7.45
Gary-Hammond	4.71	5.27	5.68	4.86
Indianapolis	5.33	4.28	4.63	4.84
Lafayette	3.36	3.49	4.31	3.12
Muncie	4.86	4.95	3.87	3.80
South Bend [4]	7.24	6.99	6.04	5.72
Terre Haute	2.52	2.29	2.37	2.37
Total, excluding Indianapolis [4]	5.94	6.25	5.52	5.32
Total, urban areas [4]	5.74	5.59	5.23	5.16
Iowa:				
Burlington	3.01	3.29	3.79	2.55
Cedar Rapids	3.75	4.05	3.28	3.48
Clinton	3.02	3.16	2.41	2.03
Council Bluffs	5.69	4.93	4.78	4.66
Des Moines	10.09	8.90	6.39	4.19
Dubuque [4]	5.43	3.66	3.68	2.66
Marshalltown	4.63	3.37	6.27	5.26
Mason City	2.64	2.63	1.71	2.19
Muscatine	5.01	1.87	4.99	1.84
Ottumwa	4.19	1.42	3.23	1.90
Sioux City	2.54	2.79	3.58	2.44
Waterloo	6.42	3.86	5.62	2.94
Total, excluding Des Moines [4]	4.16	3.38	3.86	2.95
Total, urban areas [4]	5.71	4.82	4.50	3.27

Area	1966		1965	
	Inflow [3]	Withdrawals	Inflow [3]	Withdrawals
Michigan:				
Adrian	6.33	7.72	7.21	6.02
Ann Arbor	3.77	5.31	6.18	4.91
Bay City	5.39	4.92	5.36	4.08
Detroit	8.86	10.13	9.14	8.42
Flint	7.86	8.56	6.27	6.15
Grand Rapids	8.00	8.59	5.60	5.77
Jackson	4.97	4.72	4.48	4.53
Kalamazoo	12.70	13.84	13.97	12.14
Lansing	7.35	9.19	7.14	6.74
Muskegon	6.09	6.40	4.48	4.89
Port Huron	12.95	11.72	6.12	4.40
Saginaw	6.20	6.01	4.12	4.23
Total, excluding Detroit [5]	7.57	8.17	6.20	5.86
Total, urban areas [5]	8.43	9.48	8.16	7.57
Wisconsin:				
Appleton	3.65	4.64	3.82	3.30
Green Bay	5.46	3.85	2.86	3.62
Kenosha	5.07	4.27	4.77	4.65
Madison	4.15	3.43	4.06	3.95
Manitowoc	3.16	2.74	3.34	2.40
Milwaukee	4.25	3.78	4.18	3.86
Oshkosh	4.01	4.09	4.20	3.85
Racine	4.70	4.51	4.38	5.05
Sheboygan	3.79	3.72	3.38	3.40
Total, excluding Milwaukee	4.41	3.93	3.84	3.91
Total, urban areas	4.32	3.84	4.04	3.88
7th district, 51 urban areas [6]	6.86	7.42	6.22	5.55
Rural areas:				
Illinois [4]	4.51	3.93	4.16	3.49
Indiana	5.41	5.08	7.77	4.73
Iowa	3.79	3.23	3.65	3.11
Michigan	.98	4.00	4.53	4.26
Wisconsin	3.56	2.69	2.91	2.53
Total	3.61	3.80	4.40	3.60

[1] Includes savings deposits and individuals holdings of time certificates of deposit.
[2] Average of beginning and end of month balances.
[3] Includes interest credited to accounts.
[5] Includes adjacent communities in neighboring State.
[6] Includes Battle Creek for which figures are not published separately.

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The CHAIRMAN. Thank you. Mr. Harvey?

Mr. HARVEY. Thank you, Mr. Chairman.

Mr. SHEPARDSON. If I might add one other point, this information has to be obtained from the various institutions where it originates: Individual banks, savings and loans, and similar institutions. One of the problems is the burden on these institutions of reporting what we put out, even on a sample basis. When we do not use a sample basis, thousands of institutions are involved. We are asking for more and more reports.

The CHAIRMAN. Mr. Brock?

Mr. WIDNALL. Will the gentleman yield?

Mr. Chairman, at 11 o'clock this morning the Federal National Mortgage Association announced the yield on the first issue of $530 million in-participation certificates.

I want to take this opportunity to remind the committee that we were assured by the administration, time and time and time again that the participations would not exceed a quarter percent to three-eighths percent different from Treasury offerings. I happen to know what the interest on these participations will be, but I shall respect the Treasury embargo of 11 a.m. Nevertheless, I can assure the committee that when we find out, all those who believed and trusted the administration and disputed our contention that the interest differential would be much greater, should be indignant.

This committee was misled, the Committee on Rules was misled, the House was misled and the Senate as well, purely for the purpose of passing a "must" bill.

By this action this morning, interest rates throughout the country will be pushed higher than they are at present.

This FNMA offering could not have come at a more inopportune time.

The CHAIRMAN. Will you yield to me briefly? I would like to state interest rates do not enter into the question on participations. It is a question of whether or not Government assets are sold; whether the interest rate is high or low does not enter into it. I hope the ranking minority member will join me in helping force interest rates down. That is the way to reach the question.

I certainly appreciate his sympathetic views that he has uttered here in the last few days and in the future we would like to have his support and I hope we get it. Thank you.

Mr. Brock?

Mr. BROCK. I would like to comment briefly on the chairman's statement.

I think most of the Board members here will agree with me that the problem today has arisen due to the limitation on interest rates charged on long-term Federal debts—that is the unrealistic limitation of 4¼ percent has forced the Government into the short-term market and it creates an enormous pressure in the money market.

Is that not true?

Mr. ROBERTSON. I would say that is true.

Mr. BROCK. So the legal restriction on long-term Government debt is in large measure—this has, in large measure, contributed to the problem we have.

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I would like to have you answer one question very simply: You commented earlier that if we legislatively put a minimum period of 90 days, for example, on CD's, that it might have some adverse effect. Would you elaborate on that?

Mr. ROBERTSON. The institutions which presently hold CD's with maturities of less than 90 days would find it difficult to roll these over. They would have to roll them over into a longer maturity. Whether the holders of those instruments would want to sacrifice their authority to use those funds and get them back in less than that period is the problem.

From my point of view this is not an earthshaker. I think we should widen the gap between time money and demand money. I am sure my associates will have different views on that and I would like to have them express their views if they would like.

Mr. MAISEL. I would just make one point, Mr. Congressman. In this particular market, there are many other instruments that are directly competitive with the bank CD's.

For example, there is commercial paper. Corporations are issuing instruments in this short-term money market. The person putting up the money has his choice. We must decide whether we are better off having this money go through the banking system or outside of it. In banks it is available to many borrowers. A lot of this CD money went into municipals, mortgages, and similar loans. Are we better off having these funds go through the banking system where they can go to a variety of borrowers or are we better off by forcing it to go directly to the large corporations and finance companies who have the ability to issue the smaller length notes? I think this is where advantage to the administrative decisions comes. One is able to look at this competition rather carefully and see what is likely to occur.

I think if you tried to set a 90-day minimum it would be advantageous to do so administratively. You could then see whether these large flows go into other types of paper or not. Again I think the critical question and the reason we are all having difficulties in reaching a solution is that we are dealing with competition among a vast number of institutions, a vast number of corporations and a number of markets. These are closely related. I think we must be concerned that, with an attempt to set ceiling by legislation, we are likely to find the money flowing in ways we do not want.

Mr. BROCK. One of the concerns some of us have is the graying of differentials between time and demand deposits. When you limit passbook savings to 4 percent, and then even with a 30-day note allow them to go to 5½ on CD's there is a gray area here. It seems to me, we might be able to make more distinction so the difference would represent an appropriate differential.

Mr. MITCHELL. Mr. Brock, I think the alternative is not between demand and time accounts. Corporate treasurers are conserving on their demand accounts. If they do not leave corporate money in the demand accounts, it will go into time accounts or into the market. If you prohibit banks from offering 90-day paper, then you are going to force all of these funds into the market. If that is what you want to accomplish, that is the way to do it. If you limit the CD's to 3-month maturities and leave the ceiling at 5½ percent, you are going to deny the banks an opportunity to get access to these funds.

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Mr. BROCK. May I just ask this question? My time has expired.

You do have the authority to regulate the time, the minimum time on a CD and the interest, do you not?

Mr. ROBERTSON. We can determine the rate in relation to the maturity of the obligation. We exercised that power from 1930's to 1964.

The CHAIRMAN. Mr. Weltner?

Mr. WELTNER. Thank you, Mr. Chairman.

Governor Robertson, yesterday I introduced a joint resolution which would provide, for a period of 12 months, a limitation of 5 percent that any insured bank can pay on a certificate of deposit, except where the depositor might be ineligible to hold a savings account.

Now, that would mean that individual CD's would bear a maximum rate of 5 percent by insured banks. It would not affect the money market instrument type of CD's. It seems to me that what this may do would be to assure a parity of competition between savings and loan associations and banks where consumer CD's are concerned, it being my understanding that the flow of mortgage money from the associations has been the consumer type of CD.

Might I have your reaction on that proposal?

Mr. ROBERTSON. I have not seen it, but this sounds to me like the same type of temporary expedient that has been proposed by others before this committee in differentiating between the big CD and the smaller savings account. Now this means that you still have the problem under yours.

Mr. WELTNER. The problem of what?

Mr. ROBERTSON. You still have the problem of deciding whether you draw the line between the big and the small. You draw it between business concerns and individuals.

I doubt very much the wisdom of making a distinction between what the banks can pay—not what they are willing to pay—but what they can pay, either between an individual and a business concern, or between a big deposit and a small one. You have one saving grace in yours in that you provide that this shall be for a limited period only; namely 12 months. I assume by this you mean that because of the box we happen to be in, we need a temporary expedient to get out of it, and perhaps this might work. It has some of the same features, good and bad, of the others.

Mr. WELTNER. We are not relying so much on the nature of the depositor, but on the purpose for which funds are deposited.

The small CD's are really savings accounts. They are not money market instruments, whereas the procedure that has grown up over the past 4 or 5 years is a money market instrument, the rate is negotiated—it is a bid-and-ask proposition, and it has developed for the purpose of placing the money temporarily at an advantageous interest rate in such amounts that banks can afford to pay a good rate of return on it.

Mr. ROBERTSON. Of course, you bump into one problem immediately, it seems to me, and that is trying to differentiate between savings and investments. The corporations are investing their idle funds in CD's. That is where you come out.

I can understand, from the bank's point of view why it would wish to pay more interest on one type of deposit than on another. But from the point of view of Government saying a bank cannot pay as much

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on a small deposit as on a large one, I have great difficulty in seeing that.

Mr. WELTNER. My time has also expired.

However, it seems to me that we can always find some reason for not making a specific allocation. But the problem we have here is that we have to do this at some point in some way. If it is a temporary measure, do you not think that would be a contribution?

Mr. ROBERTSON. If you feel the problem should be dealt with by legislative action, then I think that you are fully justified in taking action which is of the nature that you suggest. But you want to be sure that the problem is that difficult.

Some of this problem is based on fear and not on fact. We have the power, in my opinion, under present authority, to cope with the situation as it develops and, therefore, I would think this would be the best way to handle it and we ought to rely upon the judgment and discretion of the Board.

Now other people can differ with this and I am sure they will.

Mr. WELTNER. I notice Mr. Mitchell and Mr. Maisel are shaking their heads. My time has expired and I cannot ask any questions.

Mr. MAISEL. Could I answer the question, Mr. Chairman?

The CHAIRMAN. Go ahead, Mr. Maisel.

Mr. MAISEL. I would just point out that you have precedent on your side. Congress has differentiated between foreign balances and domestic balances, which is really a precedent of the type that you are talking about.

The reason I was shaking my head is that I think it is clear that Governor Robertson feels strongly that these differentiations should not be made, based on market instruments. I think many others on the Board feel—and this is my personal belief, as I indicated to Mr. Ottinger—that there is a great deal of sense in trying to differentiate interest rates based on the type of instrument and type of market competition.

The CHAIRMAN. Mr. Hanna?

Mr. HANNA. No questions at this time.

The CHAIRMAN. Mr. Gettys?

Mr. WIDNALL. Would the gentleman yield?

Mr. GETTYS. I will yield for a question.

Mr. WIDNALL. Mr. Maisel, you said Congress had acted in the past. I just want to clear that up. Was this not at the urging of the Federal Reserve and the Treasury?

Mr. MAISEL. Yes; but the law is on the books.

Mr. OTTINGER. Will the gentleman yield for just a unanimous consent?

Mr. GETTYS. I will yield to the extent that you will yield to me when your time comes.

Mr. OTTINGER. My time has come and gone already, unfortunately. I would like to ask unanimous consent to insert in the record a memorandum to members of the House Banking and Currency Committee on certificates of deposit by Norman Strunk, executive vice president, United States Savings & Loan League.

The Chairman. Without objection, so ordered.

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(The document referred to follows:)

MEMO TO MEMBERS OF HOUSE BANKING AND CURRENCY COMMITTEE ON CERTIFICATES OF DEPOSIT BY NORMAN STRUNK, EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS AND LOAN LEAGUE, JUNE 8, 1966

A survey completed yesterday by the United States Savings and Loan League indicates that loan commitments made by savings and loan associations in May of 1966 are down 51.1% compared to May of 1965. The following figures are a sample of 143 savings and loan associations throughout the United States with total assets of $16.4 billion. It is a random sample and reflects national trends.

Changes in loan commitments made

	1965	1966	Change	Percent change
April	$390,695,000	$312,725,000	−$77,970	−20.0
May	455,104,000	222,681,000	−232,423	−51.1

In addition to the severe reduction in loan commitments being made, interest rates have risen from 5½% to 6%, with rates of 6½% to 7% not unusual. Further, the required downpayments have increased considerably.

These figures show conclusively that under the present trend the home building and real estate markets will be drastically reduced. Unless there is prompt action, the trend will be accelerated.

We respectfully urge the House Banking and Currency Committee to enact the following provisions on an interim basis:

1. Limit consumer CDs to one maturity date and eliminate the automatic renewal provision.
2. Have a minimum maturity of six months for consumer CDs.
3. Have a maximum rate of 4½% on consumer CDs. *A 5% ceiling simply will not eliminate the diversion of funds from the home mortgage market or reduce unhealthy rate competition between commercial banks and thrift institutions.*
4. Effectively limit high rate CDs to corporate depositors in large amounts.
5. We would also recommend that reserve requirements for CDs be permitted between 6% and 10%. We would like to stress the importance of immediate action if an even more severe decline in home financing is to be prevented in the next few weeks.

The CHAIRMAN. All members received it.

Mr. GETTYS. What outflow—and I address this to each of you—if any, does the Board anticipate from thrift institutions such as savings and loans in funds after the June 30 dividend period?

Mr. ROBERTSON. This is exactly what we are trying to find out. This is the basis—one part of the basis——

Mr. GETTYS. You would defer action until you do have that knowledge?

Mr. ROBERTSON. Or until we have information which we would hope to get by June 15 to enable us to make a judgment as to what might happen.

Mr. GETTYS. Do you have any opinion what the probable outflow will be?

Mr. ROBERTSON. There is no basis upon which to make a judgment as to the amount of the outflow. You will find all sorts of statements being made. Some institutions are saying they really do not expect any outflow but want to be prepared for it if it comes.

Mr. MITCHELL. Before you came in, I was pointing out that in the Midwest there are more metropolitan bank areas in which banks are

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losing savings than there are metropolitan areas in which savings and loans are losing them. This was true in April.

Mr. GETTYS. I was told that at a bankers meeting in South Carolina yesterday. I was told the same thing.

Mr. MITCHELL. The other point we ought to bear in mind, no matter what you do to restrict competitiveness, you are not going to restrict the capacity of the individual to leave the savings and loans and buy a market instrument and this is what has happened to an overwhelmingly large degree right now.

Mr. GETTYS. One other question. I know we have not discussed this. CD's have increased in 5 years from $1.1 billion to $17.4 billion. Where has that money come from?

Mr. MITCHELL. Mostly out of corporate balances and out of the market.

Mr. GETTYS. Not out of savings and thrift institutions?

Mr. MITCHELL. No. In the first place——

Mr. GETTYS. Do they have investment money or savings in savings and loans?

Mr. MITCHELL. The corporate negotiable CD's are made up principally of foreign balances, corporate balances and State and local pension funds and none of these are eligible for passbook savings.

Mr. GETTYS. Governor Robertson, I believe you hold that a great deal of the furor at the present time is based on fear and not fact.

Mr. ROBERTSON. I do.

Mr. GETTYS. Is that opinion shared by the majority of Governors? I believe Mr. Maisel differs to some degree.

Mr. MITCHELL. I think it is apprehension. I believe there are many savings and loans and banks that do not know what their flows are going to be like in the next 2 or 3 months and they are waiting to find out. They are being cautious.

Mr. GETTYS. Thank you. My time has expired.

The CHAIRMAN. If I am correct, we have Mr. Todd and Mr. Hansen and Mr. Stephens who have not asked questions. So if you will, about 4 minutes each and observe the time, please, and all of you will have an opportunity to ask questions of the Board and we will reserve the right, Governor Robertson, to submit questions in writing to you with the request that you answer them when you examine your transcript testimony.

Mr. ROBERTSON. We will be very glad to.

The CHAIRMAN. We will probably exercise that right and it is possible that we will want you back. We do not know yet. But we will go ahead and give these other members an opportunity now. Mr. Todd?

Mr. TODD. Thank you, Mr. Chairman.

A constituent of mine, Professor Myron Ross, has written a paper questioning the efficacy of Operation Twist. I would appreciate it if the staff would provide each member of the Board a copy of the paper—and then if the Board will provide me with a comment on this paper.

The CHAIRMAN. Without objection, the clerk will do that.

Mr. ROBERTSON. You mean you want each of us to give an analysis?

Mr. TODD. I would appreciate some statement from the Board as to what errors may be contained in this paper because it indicates that Operation Twist increases the balance of payments by only $154 mil-

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lion and obviously this is not enough to be worthwhile. It means Operation Twist was ill conceived.

Mr. ROBERTSON. It was, and that ought to be an answer to your paper.

Mr. TODD. Secondly, I have a statement I would like to read for the record and if there is time probably you can respond to it and the others can respond later.

It seems to me that our so-called tight money policy is limited for all practical purposes to high interest rates. There has been an exceptionally rapid increase in the money supply, which is, in effect, a loose money policy, during the last year. Does not this reflect the inability of monetary policy to dampen the overheating of our economy? Does not this mean that fiscal policy such as a tax increase must be utilized if our economy is to be dampened at this time?

Mr. ROBERTSON. I would say that the individual who wrote this apparently had not heard of the assertions which have been made to members of this committee by the savings and loan associations of the country, by the small banks of the country, and by the large banks of the country to the effect that tight money really is biting, and that it is more difficult today to get loans than before. There is some merit to the position which your correspondent takes.

Mr. TODD. Governor, I wrote that.

Mr. ROBERTSON. There is merit to your position, then, Mr. Todd, that monetary policy has not been as tight in some sectors as in other areas of the economy. For example, the large city banks, by virtue of their ability to go out and buy funds if they wish, have not been restricted as much as the smaller institutions and the savings and loans which have not been in this same sort of position.

Nevertheless, it has been tightened in the past 3 months.

Mr. TODD. The reason I say high interest rates where the only aspect of our tight money policy—it is an oversimplification, but actually we have expanded our money supply at the most rapid rate since World War II—I believe and this is in a document from the recent report from the St. Louis Federal Reserve Bank and this is what I mean that as far as money supply is concerned, it has been relatively loose. It does not mean that the demand is not utilizing all the money.

Mr. ROBERTSON. Yes, but in the past month, if you will take a look at the figure, you see this is really beginning to bite.

Mr. TODD. The other part of the question, is not fiscal policy required to dampen down this demand?

Mr. ROBERTSON. Very much to be desired. Because otherwise monetary policy must become so tight that its effects on some areas of the economy will be unduly severe.

Mr. TODD. Thank you. My time has expired.

The CHAIRMAN. Mr. Hansen?

Mr. HANSEN. Thank you, Mr. Chairman.

Governor Robertson, did I understand you correctly when I thought you said the Board now has the authority to set rates and to regulate maturities and the amounts involved in each case with regard to rates that apply?

Mr. ROBERTSON. Not as to amounts. We have the power to set the ceilings on different maturities or types of deposit, but we do not have the power to differentiate between size of deposit.

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Mr. HANSEN. Would it be helpful to have that delineated in the law, the size with relation to the rate and maturity?

Mr. ROBERTSON. We have taken the position yesterday that as a temporary expedient, this is worth consideration. I have great reluctance in applying this sort of thing. I think we can better deal with the problem straight across the board on a maturity basis than by attempting to differentiate between the size of accounts.

Mr. HANSEN. The point that I am getting at is one which some of my constituents have referred to with regard to, for instance, the $25 CD at the high rate and this seems to be one of the chief objections, at least in my area, items below a hundred dollars, for example. They take the position that if they want to invest their money in small amounts they should take passbook rates or E-bond rates, for example.

Mr. ROBERTSON. I would say we have the power to cope with this problem, too, in my own personal opinion, because we can prohibit multiple maturities. We can require there be a single maturity. This means that it has to be renewed. The so-called gimmick instruments which you are talking about—which do constitute one of the chief means of competition against the savings and loans—provide for automatic renewal every 30 days, and you can pull your own money out at any time. This means it is exactly the equivalent of the savings account except as to rate. We are in a position to cope with this problem.

Mr. HANSEN. In other words, you can cope with that? Would it help if you were directed to do so?

Mr. ROBERTSON. This I think is a matter for Congress to decide, whether it should or should not. I would think it better not.

Mr. HANSEN. Thank you. I believe my time has expired.

The CHAIRMAN. Mr. Stephens I believe is the last one.

Mr. STEPHENS. Thank you, Mr. Chairman. I am sorry I missed you yesterday.

I wanted to ask the question. In 1961 we changed the regulation Q and when we did that the liberalization of investment in certificates of deposit occurred. It looks to me like the proposals that have now been made are putting on a ceiling but on a different interest rate just like Q.

Mr. Weltner had proposed that we have a 5-percent ceiling and that 5-percent ceiling would have a divider on it. In the testimony that Mr. Barr gave, he made a suggestion that we not have—that we have a 5 percent level and that it apply to everything and not get a differentiation—between different kinds of investments. And then I asked the witness if he would mind if an alteration made by the Federal Home Loan Bank Board to allow a variable rate up to 5 percent would be all right.

What would you think of the proposal to make a straight 5 percent without any other restrictions or restraints tied to it so it would have an effect on regulation Q?

Mr. ROBERTSON. This would automatically provide a maximum, with no administrative authority in the Federal Reserve to go above 5 percent. Do I understand you correctly?

Mr. STEPHENS. I believe so.

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Mr. ROBERTSON. This has the defect, it seems to me of saying that a rate which the Congress thinks is a maximum rate for today is really a maximum rate for all time.

Mr. STEPHENS. Let me ask you this. Has this not been done already in the States with respect to usury laws?

Mr. ROBERTSON. With respect to usury you have a different problem.

Mr. STEPHENS. We have 5½ percent and we are not far away from the usury law rate now with that except that you have a lot of differentiation because there are variations between States and the type of instruments. But we do have usury laws and you cannot change usury laws in the States without everybody called a friend of the loan shark.

Mr. ROBERTSON. But you would not want to gear your Federal legislation to all the usury laws among the 50 States. This is a matter where people can have varying judgments, as many States have.

Mr. STEPHENS. Why could we not do this? Why could we not just say we would not change the interest rates of everybody and institutions and it can go up to what the usury laws are in the individual State and forget the regulation from the Federal Reserve?

Mr. ROBERTSON. This would eliminate regulation Q, by substituting the usury laws of each State. This all depends on whether you think it is desirable to have regulation of interest rates that banks can pay on time and savings deposits. As I have stated before in my own point of view we would be better off if we did not have any ceilings, but that sort of position should be taken when competitive relationships between all kinds of financial institutions are reasonably stable so that they can make adjustments gradually.

We have had rates lower for banks than for savings and loan institutions, and competitive practices were built up on that basis. The abrupt change on December 6, 1965, created the problem.

Mr. STEPHENS. If you put in an equal competitive rate between the savings and loan and the bank——

Mr. ROBERTSON. In my opinion this should be. You should have the same sort of regulatory power over one type of institution as the other.

Mr. STEPHENS. Why cannot the Federal Reserve do it?

Mr. ROBERTSON. We have no power with respect to other kinds of institutions. Our power is limited to commercial banks, to member banks.

Mr. STEPHENS. Could you not say to the major banks we will have the same rates as savings and loans?

Mr. ROBERTSON. But they do not have any ceilings. There is no power in any agency.

Mr. STEPHENS. They certainly exercise the power.

Mr. ROBERTSON. There is no ceiling whatsoever as I understand it with respect to them except that the Federal Home Loan Bank Board has taken the position, if you want to come in to borrow from us you hold your rates at a certain place. But this is an indirect way of achieving this and if they are in a position where they do not have to borrow there is no ceiling.

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Mr. STEPHENS. I know when I go to borrow money, I say 5 percent. It has gone up to 6 percent the last time I renewed my loan. Thank you very much.

The CHAIRMAN. Mr. St Germain.

Mr. ST GERMAIN. Last year the Federal Reserve Board in essence allowed the banks to go into the securities business.

Mr. ROBERTSON. Will you state that again?

Mr. ST GERMAIN. The banks—the Board allowed the member banks to reenter the securities business.

Mr. ROBERTSON. No, the Board did not do this at all.

Mr. ST GERMAIN. This was not a Board action?

Mr. ROBERTSON. Not at all. The question to us was simply whether or not this particular action of a particular bank would violate certain provisions of the Federal Reserve Act. It did not violate those. We did not give our approval or disapproval. This was done by another agency of Government.

Mr. ST GERMAIN. Have you gentlemen taken a stand on this?

Mr. ROBERTSON. The Board has not had the problem to decide and has not decided it.

Mr. ST GERMAIN. As an individual what would you say?

Mr. ROBERTSON. I would prefer not to give a decision on this without very careful study.

Mr. ST GERMAIN. I am told by counsel that under the Federal Reserve Act you are charged with the responsibility of deciding whether the banks can go into the securities business.

Mr. ROBERTSON. That is not quite true. I would be very glad to submit to you a memorandum of our counsel on this problem.

Mr. ST GERMAIN. That would be appreciated.

(Mr. St Germain submitted the following information for the record:)

According to the financial press (Washington Financial Report, Oct. 11, 1965), the Federal Reserve Board on March 16, 1965, informed First National City Bank, New York, that the bank's proposed operation of a mutual investment company is permissible under the Federal Reserve Act. The Board's decision was limited to the statutory prohibition against interlocking management of banks and investment companies and the Board expressly refused to say whether or not such a plan might incur the criminal penalties contained in Title 12 U.S.C. Section 378.

Because of an alleged "lack of public interest" this precedent-shattering decision was not made public by the Board until October 7, 1965, more than 6 months after the permission was reportedly granted to the bank on a confidential basis.

Although section 24(7) of Title 12 clearly recognizes Congress' desire that national banks assist States and municipalities in the public sale and distribution of their debt obligations for worthwhile public projects, the Reserve Board construes that provision quite narrowly. Therefore, how the Board, without any statutory blessing or basis whatever, can conclude that the many provisions in the laws against bank activities in general securities operations do not prohibit a bank-sponsored and bank-operated mutual fund is beyond my comprehension.

Following is the opinion of the Federal Reserve Board that such an activity by a member bank is entirely legal under the Federal Reserve Act:

12 C.F.R. § 218.111. Interlocking relationships between bank and its commingled investment account.

(a) The Board of Governors was asked recently whether the establishment of a proposed "Commingled Investment Account" ("Account") by a national bank would involve a violation of section 32 of the Banking Act of 1933 in view of the interlocking relationships that would exist between the bank and Account.

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(b) From the information submitted, it was understood that Account would comprise a commingled fund, to be operated under the effective control of the bank, for the collective investment of sums of money that might otherwise be handled individually by the bank as managing agent. It was understood further that the Comptroller of the Currency had taken the position that Account would be an eligible operation for a national bank under his Regulation 9, "Fiduciary Powers of National Banks and Collective Investment Funds" (Part 9 of this title). The bank had advised the Board that the Securities and Exchange Commission was of the view that Account would be a "registered investment company" within the meaning of the Investment Company Act of 1940, and that participating interests in Account would be "securities" subject to the registration requiremens of the Securities Act of 1933.

(c) The information submitted showed also that the minimum individual participation that would be permitted in Account would be $10,000, while the maximum acceptable individual investment would be half a million dollars; that there would be no "load" or payment by customers for the privilege of investment in Account; and that: "The availability of the Commingled Account would not be given publicity by the Bank except in connection with the promotion of its fiduciary services in general and the Bank would not advertise or publicize the Commingled Account as such. Participations in the Commingled Account are to be made available only on the premises of the Bank (including its branches), or to persons who are already customers of the Bank in other connections, or in response to unsolicited requests."

(d) Such information indicated further that participations would be received by the bank as agent, under a broad authorization signed by the customer, substantially equivalent to the power of attorney under which customers currently deposit their funds for individual investment, and that the participations would not be received "in trust."

(e) The Board understood that Account would be required to comply with certain requirements of the Federal securities laws not applicable to an ordinary common trust fund operated by a bank. In particular, supervision of Account would be in the hands of a committee to be initially appointed by the bank, but subsequently elected by participants having a majority of the units of participation in Account. At least one member of the committee would be entirely independent of the bank, but the remaining members would be officers in the trust department of the bank.

(f) The committee would make a management agreement with the bank under which the bank would be responsible for managing Account's investments, have custody of its assets, and maintain its books and records. The management agreement would be renewed annually if approved by the committee, including a "majority" of the independent members, or by a vote of participants having a majority of the units of participation. The agreement would be terminable on 60 days' notice by the committee, by such a majority of the participants, or by the bank, and would terminate automatically if assigned by the bank.

(g) It was understood also that the bank would receive as annual compensation for its services one-half of one percent of Account's average net assets. Account would also pay for its own independent professional services, including legal, auditing, and accounting services, as well as the cost of maintaining its registration and qualification under the Federal securities laws.

(h) Initially, the assets of Account would be divided into units of participation of an arbitrary value, and each customer would be credited with a number of units proportionate to his investment. Subsequently, the assets of Account would be valued at regular intervals, and divided by the number of units outstanding. New investors would receive units at their current value, determined in this way, according to the amount invested. Each customer would receive a receipt evidencing the number of units to which he was entitled. The receipts themselves would be nontransferable, but it would be possible for a customer to arrange with Account for the transfer of his units to someone else. A customer could terminate his participation at any time and withdraw the current value of his units.

(i) Section 32 of the Banking Act of 1933 provides in relevant part that: "No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve [at] the same time as an officer, director, or employee of any member bank * * *."

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(j) The Board concluded, based on its understanding of the proposal and on the general principles that have been developed in respect to the application of section 32, that the bank and Account would constitute a single entity for the purposes of section 32, at least so long as the operation of Account conformed to the representations made by the bank and outlined herein. Accordingly, the Board said that section 32 would not forbid officers of the bank to serve on Account's committee, since Account would be regarded as nothing more than an arm or department of the bank.

(k) In conclusion, the Board called attention to section 21 of the Banking Act of 1933 which, briefly, forbids a securities firm or organization to engage in the business of receiving deposits, subject to certain exceptions. However, since section 21 is a criminal statute, the Board has followed the policy of not expressing views as to its meaning. (1934 Federal Reserve Bulletin 41, 543). The Board, therefore, expressed no position with respect to whether the section might be held applicable to the establishment and operation of the proposed "Commingled Investment Account". (12 U.S.C. 248(i). Interprets or applies 12 U.S.C. 78)

Mr. ST GERMAIN. Mr. Chairman, I have a telegram here from one of my commercial banks. I feel it only fair and equitable and I would like to have it made a part of the record.

The CHAIRMAN. Without objection, so ordered.

(The telegram referred to follows:)

PROVIDENCE, R.I., *June 3, 1966.*

Hon. FERNAND J. ST GERMAIN,
House of Representatives,
Washington, D.C.:

Relative to current hearings on certificate of deposit interest rates wish to state that almost 100 percent of certificates issued by this bank have come from our own demand deposits and not from savings institutions. We also believe that setting minimum maturities and maximum rates on amounts under $100,000 would severely penalize banks outside major money markets who are forced to pay competitive rates for smaller amounts. Believe Federal Reserve and FDIC studies now underway will bear this out. Also believe any regulation forthcoming should be at discretion of banking authorities and not mandatory and that any regulation should be on the basis of equality and apply to savings institutions of all kinds as well as to commercial banks. Probably the best solution to the problem would be the elimination of regulation Q which would permit the market to seek its own level in view of current conditions.

CLARENCE H. GIFFORD, Jr.,
President, Rhode Island Hospital Trust.

Mr. ST GERMAIN. I have no further questions.

The CHAIRMAN. We will take a 4-minute recess and resume at 10 o'clock on another matter.

(Whereupon, at 9:55 a.m., the committee adjourned, to reconvene subject to the call of the Chair.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, JUNE 16, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Ashley, Moorhead, St Germain, Gonzalez, Weltner, Hanna, Grabowski, Todd, McGrath, Hansen, Annunzio, Rees, Widnall, Fino, Mrs. Dwyer, Halpern, Brock, Talcott, Clawson, Johnson, Stanton, and Mize.

The Chairman. The committee will please come to order.

This morning the committee continues consideration of H.R. 14026, relating to negotiable certificates of deposit.

At the request of several members we again have as our witness Chairman William McChesney Martin, Jr., of the Federal Reserve Board.

While there is no committee agreement or understanding on any one proposal to stop this terrible rate war now in progress, one thing we do know from the testimony is that it was started by the Federal Reserve Board and that this same Federal Reserve Board has the present power to stop it.

I do not suggest that the Board intended to harm the thousands of thrift institutions and the hundreds of thousands of homebuilders and home buyers, but that has been the result.

Chairman Martin has been called back to assist the committee in arriving at an effective solution to this destructive and dangerous rate competition. He has suggested that congressional action may be appropriate inasmuch as the Federal Reserve Board has no present plans to act to stop the rate war.

I might add, for Mr. Martin's information as well as all interested parties, that the committee agreed this past Monday that it would act on a CD bill. We are working right along to come up with the best possible solution and perhaps Chairman Martin can give us some useful information.

Of course, when I say consideration of H.R. 14026, I mean all of these bills. There are several recent bills, including the one introduced by the chairman, and one introduced by Mr. Reuss, one introduced by Mr. Hanna, one by Mr. Weltner, and one by Mr. Rees of California were sent to all members of the committee for their consideration.

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Now, we would like to get through this morning as quickly as possible, giving members time to ask timely questions.

Let us see if we can agree on a time limit. However, we do not have all of our members here as yet.

Mr. MARTIN. My statement is very short, Mr. Chairman.

The CHAIRMAN. So it is. Suppose you go ahead, Mr. Martin, and present your statement, and then by that time we will have more members here and we will take up the question of closing the hearings.

Mr. MARTIN. Fine.

STATEMENT OF HON. WILLIAM McC. MARTIN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; ACCOMPANIED BY HOWARD HACKLEY, GENERAL COUNSEL; AND J. CHARLES PARTEE, ASSISTANT DIRECTOR, DIVISION OF RESEARCH AND STATISTICS, FEDERAL RESERVE SYSTEM—Resumed

Mr. MARTIN. I have been asked to comment on the draft bill prepared as a result of your committee's meeting of June 13.

If the problem you are most concerned with is to insure against too sharp a cutback in residential construction, we think the best course is to inject funds directly into the mortgage market by increasing FNMA's purchase authority. I am pleased to note that the draft bill includes, in section 5, provisions to authorize such an increase.

The bill would also broaden the permissible range of reserve requirements on time and savings deposits to a range of 3 to 10 percent, and this is agreeable to the Board.

The bill also includes authority to differentiate on any reasonable economic basis among deposits for purposes of reserve requirements and interest ceilings. This would increase flexibility to deal with unforeseen situations as they develop.

The draft bill would also rewrite section 14(b) of the Federal Reserve Act, relating to purchase of Government obligations. The principal purpose is apparently to make obligations of the Federal home loan banks and those issued by FNMA in its secondary market operations eligible for purchase. The impact of such purchases on bank reserves could be neutralized by offsetting sales of direct Treasury obligations, but this would increase the cost of Treasury borowing. The potential effect of open market purchase of Government agency obligations of all kinds—not just these two—needs extensive study at an analytical and technical level. Such a study is now underway.

The revision relating to purchase of these instruments, however, includes changes which raise basic questions relating to the conduct of monetary policy. Thus, the draft bill apparently would make purchases under section 14(b) subject to regulations by the Board, although it would also continue the present provisions making such purchases subject to direction and regulations of the Federal Open Market Committee. It also provides for a mechanism under which the Secretary of the Treasury, after consultation with the Secretary of Housing and Urban Development and the Chairman of the Federal Home Loan Bank Board, would advise the Federal Open Market Committee as to "open market policy with respect to" FHLB and FNMA obligations. The result, I believe, would be to increase pressures to divert open

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market operations from general economic objectives to the support of specific markets for credit. As a consequence, the effectiveness of monetary policy as a general instrument for economic stabilization would be threatened.

In addition to these substantive provisions, the draft bill contains a number of expressions of the sense of Congress. One such expression urges the Board to prohibit interest on time deposits held less than 91 days. Since, roughly, half of the outstanding negotiable CD's of $100,000 or over mature in 3 months or less, and new instruments with maturities as short as 3 to 4 months are selling at yields of 5½ percent, such an action could result in a sharp contraction of outstanding CD's. This would force many banks to sell assets, and might have serious adverse effects on the mortgage market as well as the market for municipal obligations.

Another "sense of Congress" expression favors a prohibition of interest on savings deposits held less than 30 days. While this would pose no problem for banks that compute interest on the minimum balance held during a quarter, banks that compute interest on a daily basis could face serious operating difficulties in complying with the requirement where a depositor makes frequent deposits and withdrawals.

The draft expresses the sense of Congress that reserve requirements should be raised on "large" negotiable CD's and all CD's with "near-term" maturities. Small changes in reserve requirements would have relatively little effect, either in increasing liquidity or in reducing the profit to the bank from selling CD's and investing the proceeds (the reduction would be about one-twentieth of a percentage point for each 1 percent increase in reserve requirements). Large changes under present circumstances could have serious and unpredictable effects on credit availability to particular sectors and regions of the economy. In addition, differentiation in reserve requirements between large and small CD's could post administrative difficulties. For example, higher requirements on large CD's could be evaded by issuing smaller denominations in multiple units.

The increased flexibility proposed by this bill could be utilized more effectively if the bill permitted graduation of reserve requirements by size of bank. This would greatly improve the competitive position of small banks. Equivalent requirements also should be extended to all insured commercial banks so that the reserve burden would be shared by all banks enjoying the benefits of deposit insurance.

We have mentioned this, as you know, Mr. Chairman, several times in our annual report, and I have a bill on graduated reserve requirements which I thought I might just submit for the record.

The CHAIRMAN. Suppose it is placed in the record at this point, Mr. Chairman.

Mr. MARTIN. Right.

(The draft of the bill referred to follows:)

[Draft]

A BILL To establish a graduated system of reserve requirements for all insured banks, to authorize Federal Reserve banks to extend credit to all insured banks, and for other purposes

Be it enacted by the Senate and House of Representatives in Congress assembled, That the second, third, fourth, fifth, and sixth paragraphs of section 19

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of the Federal Reserve Act, as amended (12 U.S.C. 462, 462b), are deleted and the following paragraphs substituted in lieu thereof:

"Every insured bank engaged in the business of receiving deposits subject to check shall establish and maintain a reserve balance with the Federal reserve bank of the Federal reserve district in which it is located that, together with its currency and coin, shall be not less than an amount equal to the sum of (a) 4 per cent of its time deposits and (b) the following percentages of its demand deposits: (1) 7 per cent of its demand deposits to the extent that they do not exceed $5 million; (2) 12 per cent to the extent that they exceed $5 million but do not exceed $100 million; and (3) 16½ per cent to the extent that they exceed $100 million.

"Notwithstanding the other provisions of this section, the Board of Governors of the Federal Reserve System, upon the affirmative vote of not less than four of its members, may by regulation change the requirements as to reserves to be maintained against demand or time deposits or both whenever, in the Board's judgment, such action is necessary in order to prevent injurious credit expansion or contraction or is otherwise desirable in the light of the general credit situation of the country; *Provided, however,* That (1) the required percentage of time deposits shall not be fixed at less than 3 per cent nor more than 10 per cent, (2) the percentage of demand deposits not exceeding $5 million shall not be fixed at less than 5 per cent nor more than 9 per cent, (3) the percentage of demand deposits exceeding $5 million and not exceeding $100 million shall not be fixed at less than 8 per cent nor more than 20 per cent, (4) the percentage of demand deposits above $100 million shall not be fixed at less than 10 per cent nor more than 22 per cent, and (5) the dollar amounts above specified may not be changed except that the $5 million figure may be increased to not more than $10 million and the $100 million figure may be increased to not more than $500 million. Subject to the limitations above prescribed, the Board may fix different percentages for different classes of time deposits according to such reasonable basis or bases as the Board may determine.

"Every insured bank shall make reports concerning its reserves to the Board of Governors of the Federal Reserve System at such time and in such form as the Board may require.

"For every violation of this section by an insured bank, in addition to the penalties that may be authorized by other provisions of law, such bank shall be subject to a penalty not exceeding $1,000 per day for each day during which such violation continues. Such penalty may be assessed by the Board of Governors of the Federal Reserve System, in its discretion, and, when so assessed, may be collected by the Federal Reserve Bank by suit or otherwise.

"Whenever it shall appear to the Board of Governors that an insured bank has willfully violated or continued to violate the provisions of this section regarding reserves or reports with respect thereto, the Board, after having warned the bank to discontinue such violations, may report such facts to the Federal Deposit Insurance Corporation which shall immediately terminate the status of the bank as an insured bank in accordance with the provisions of section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1813(a))."

SEC. 2. The first paragraph of section 19 of the Federal Reserve Act (12 U.S.C. 461) is amended by adding at the end thereof the following sentence:

"For purposes of this section, the terms 'insured bank' and 'noninsured bank' shall have the meanings given those terms by section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h))."

SEC. 3. The second sentence of the eighth paragraph of section 19 of the Federal Reserve Act (12 U.S.C. 464) is amended by changing the words "member bank" to "insured bank" and the words "nonmember bank" to "noninsured bank".

SEC. 4. The ninth, tenth, and fourteenth paragraphs of section 19 of the Federal Reserve Act (12 U.S.C. 464, 465, 462a-1) are amended by changing the words "member bank" wherever they occur in such paragraphs to "insured bank".

SEC. 5. Subsection (e) of section 11 of the Federal Reserve Act (12 U.S.C. 248(e)) is repealed.

SEC. 6. Every Federal Reserve Bank is authorized to discount paper for, and make advances to, any insured bank in its district to the same extent and subject to the same limitations as such Federal Reserve Bank is authorized to discount paper for, and make advances to, member banks under provisions of the Federal Reserve Act.

Mr. MARTIN. Finally, the bill would urge the Board to limit the rate of interest paid on time deposits held by depositors eligible to hold

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savings deposits to levels "appropriate in the light of rates which may soundly be paid by thrift institutions generally."

The difficulty I see with this kind of expression of the sense of Congress is that it seems to indicate a belief that present levels are not appropriate, without saying what those levels should be. I want to make my own position on this as clear as possible. I cannot tell you today what I would do next month with broadened authority to change regulation Q ceilings and, of course, I cannot tell you what other Board members would do. As you have observed during these hearings, there are differences of view among the Board members. We are, however, fully agreed that it is better to leave a decision of this kind to an administrative agency with discretion to take whatever action seems appropriate in the light of changing circumstances. I can understand your position; you are not sure that the Board will use whatever authority you wish to give us to differentiate between the money-market CD's and other time deposits, and you would like some guarantee. But I cannot give you that guarantee. I think it would be a mistake for any administrative agency to make such a commitment. I also think it would be a mistake for you to compel action. But, if you wish to do so, and, of course, this is entirely within your prerogatives, I think it is only fair that you also take the responsibility for the action. Therefore, I believe if you are not willing to leave this to Board discretion, you should specify in the bill the rate you think should be put in effect, as the Weltner and Hanna bills would do.

If you fix a rate, rather than leaving it to our discretion, you face a difficult choice, it seems to me. The 5-percent ceiling, as of last month, would have had only a moderate overall effect in curbing banks' ability to compete for savings in small denominations. Only about 190 banks were offering rates in May exceeding 5 percent on consumer-type time deposits. The amount of deposits of the types on which rates in excess of 5 percent were offered was $3.5 billion. A 5-percent ceiling might well put some individual banks in a difficult position with respect to holding their existing deposits and this number would grow if market rates continued to rise. Whether such a ceiling would step up new mortgage commitments by savings and loan associations depends on the extent to which they may be holding back out of fear that their commercial bank competitors may go above 5 percent in bidding for funds.

If, on the other hand, you fix a 4½-percent ceiling, you run the risk—as I have previously testified—of preventing a large number of banks from meeting competition for savings funds. More than 900 banks in May were offering rates exceeding 4½ percent on consumer-type time deposits. The amount of deposits of the type on which rates of more than 4½ percent were being offered was $8.5 billion, of which over $3 billion was in member banks in the San Francisco district. Forcing them to roll bank rates offered to the 4.5-percent level would almost certainly cause them to lose a significant portion of these funds. It would also make it impossible for them to compete effectively in the future. Such a ceiling probably would have the effect of penalizing most the growing and capital-short parts of the country, and the attendant loss of access to credit facilities by small businesses and other borrowers heavily dependent upon these banks might be more serious than the problems the committee is now seeking to resolve.

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Let me make just one additional comment that I have been thinking about a good bit in the last few weeks, regarding the role of the saver in this.

We must not forget him entirely, because we are in a period where borrowings are clearly exceeding savings and we don't want to discourage, in any way, the saver. We want to do everything we can to support and help the institutions involved in this, but at the same time, we don't want to penalize thrift, certainly not at a time when borrowing is exceeding savings generally across the country.

The CHAIRMAN. At the same time, we don't want to discourage people from supporting the private capital markets who would be willing to assume the normal risk of making more money than they would be getting on bank deposits.

Mr. MARTIN. I don't know how that works, Mr. Chairman.

The CHAIRMAN. Well, I will not go into that now.

Mr. MARTIN. One of the problems at the present time, as between the institutions, is that the people are withdrawing funds for more attractive instruments outside both savings and loan institutions and banks. It isn't just a shift from one kind of financial institution to the other.

The CHAIRMAN. Well, Mr. Martin, your statement is a very forthright one. It doesn't really give us any more information than we already have had, because you have made your position plain, I think, all along. And I think we have reached a point here when the Congress will have to take action if the Congress wants to say that the Federal Reserve is not at all independent from the Government, and that the Federal Reserve must respect the President's authority over that agency, I think we will just have to meet that head on. And, I think, that the situation has become so serious and so critical that, in the interest of the future welfare of this country, that we should undertake that responsibility.

The independence that you claim that you have, you have made very plain in recent years. You do not consider that anybody in the Government, Federal Government, can overrule any decision of the Board. That is your decision, isn't it, Mr. Martin?

Mr. MARTIN. As I have stated in this statement, if you want to set a rate or if you want to change the law, then——

The CHAIRMAN. That is not the answer to my question.

Mr. MARTIN. That is the answer——

The CHAIRMAN. No, you are talking about the law; I am talking about the Federal Government.

You know that the Employment Act says that the Federal Government shall do certain things in coordination, and the Federal Government contemplates, I assume, the President of the United States as the head of the Federal Government. And I just ask you this question, a very simple one, that it is your interpretation that the President does not have any control or power or authority over the action of the Federal Reserve Board?

Mr. MARTIN. I have repeatedly stated that the law, as presently constituted, makes us responsible to the Congress, not to the President.

The CHAIRMAN. Now, you state that you are independent. Since

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neither the Federal Reserve Act, nor any of the amendments, uses the word "independent," nor is there anything in the law or in the debates of the Congress, the House or the Senate, nor in the committee reports, that make any declaration or expression of any intention of giving the Federal Reserve independence, how do you justify your independence, except that you got out from under the Government and you don't have to come to Congress for appropriations, and therefore, you can thumb your nose at the Congress, because you have money to operate on.

What other grounds of independence do you have, Mr. Martin?

Mr. MARTIN. There has never been any thumbing of our nose or any discussion of independence from the right or the capacity of this committee or the Congress to legislate any changes in the law that you see proper.

The CHAIRMAN. If that December 6 increase in interest rates of 37½ percent was not thumbing your nose at the President and the Congress, I don't know what you would call it. That has caused devastation in our country, it is causing all kinds of trouble. It will cause the destruction of financial institutions in competition with commercial banks, and also cause harm to the banks themselves, particularly the small banks.

Mr. MARTIN. I testified at some length in December on the reasons for that action, and you had me up here within 5 days of the time the action was taken.

The CHAIRMAN. Well, with all due respect to you, Mr. Martin, you didn't give reasons, you gave excuses.

Mr. MARTIN. Well, that is a matter of judgment, Mr. Chairman.

The CHAIRMAN. I know it is.

The reasons you gave from your viewpoint were that these half a dozen banks were hurting on account of the $16½ billion in CD's. People had bought them at 4 percent and the banks couldn't roll them over and couldn't renew them at 4 percent and they had to have a much higher ceiling and you had to grant that ceiling of 5½ percent immediately. And, I believe, your testimony, without dispute, discloses that that was really the problem that was hurting at the time, isn't that correct?

Mr. MARTIN. No, that is not correct. The problem that was hurting at the time was an inflationary situation that was developing in the country, which has been in my judgment, fully demonstrated by subsequent events.

The CHAIRMAN. Well, Mr. Balderson said, you just had to do it. You remember, he spoke out of church over there, and just admitted we had to do it because we had so many CD's coming due.

Now, these CD's, can't they be put up with a local bank in order to get the credit, with the Federal Reserve, a member of the Federal Reserve System?

Mr. MARTIN. Certainly, the assets behind them can.

The CHAIRMAN. Why should there be any liquidity squeeze, then, if they are eligible for rediscount at Federal Reserve banks?

Mr. MARTIN. This would involve a penalty rate because the banks don't have enough assets that qualify as eligible paper.

The CHAIRMAN. Don't have enough assets?

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Mr. MARTIN. This is purely a matter of eligibility under the present statute. The member banks may borrow on ineligible paper at a penalty rate or on eligible paper at the regular discount rate, at any time. The discount window has never been closed to them. They may have to pay more as a result of the increase in the rate.

The CHAIRMAN. I have a short statement here that I would like to go into, and then I will deal with that.

Chairman Martin, in your statement before this committee on June 8, you stressed that everyone, including commercial banks, are feeling the effects of higher interest rates and tighter money, but that you do not feel it is the Board's responsibility to consider the specific needs of particular financial institutions or particular industries in making your general monetary decisions. You have to look at the economy as a whole, is that correct?

Mr. MARTIN. That is correct.

The CHAIRMAN. I thought you said that.

Now, how do you explain this statement from an article in yesterday's Wall Street Journal, June 15:

> The easier tone in the Federal funds market, bankers said, indicates that the Federal Reserve System has been seeing to it more funds were available to help the banks through the June 15 money pinch.

If this is true, you are willing to help the big banks but not the thrift industry and housing. As a Government official, how can you discriminate and make special exceptions for the big banks from your general monetary operations? Why should you assist one but not the other?

This same article points out that the banks will be saved from a serious shortage by huge deposits of the Treasury's tax collections on which they will have to pay no interest at all.

Will the thrift institutions share in this or will only the commercial banks be favored with this huge influx of the public's money?

Would you like to comment on that article in yesterday's Wall Street Journal?

(The article referred to follows:)

[From the Wall Street Journal, June 15, 1966]

BIG NEW YORK BANKS SEE NO MAJOR STRAIN IN JUNE CD EXPIRATIONS

THEY EXPECT DEMAND DEPOSITS BY TREASURY TO OFFSET CASH DRAIN AS $3.9 BILLION OF CD'S MATURE

(By a Wall Street Journal Staff Reporter)

NEW YORK.—Officials of major New York City banks said their institutions appear to be coming through the latest round of their money squeeze without too much strain.

The money pinch results in part from the fact that a large amount of certificates of deposit held by corporations are maturing in June. In all, some $3.9 billion of fixed-term negotiable large-denomination CD's are coming due this month. Of the total, $321 million came due last Friday and an additional $717 million of the CD's will be maturing today.

Corporations, having already made heavy quarterly dividend payments, are expected to use the funds mainly to pay a Federal income tax installment due today.

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Bankers indicated yesterday that while they don't expect to replace a sizable rtion of the maturing CD's, they look for an increase in demand deposits to set the drain, as the Government deposits the tax receipts in its accounts at banks.

The banks also have found some help in balancing their money position by ranging overnight loans of uncommitted reserves at the Federal Reserve banks—called Federal funds. After trading at a historic high of 5⅜ percent as re-ntly as last Friday, these funds have been available to banks that need them rates as low as 4⅞ percent during the past 2 days, though some transactions ve taken place at 5⅛ percent. The easier tone in the Federal funds market, nkers said, indicates that the Federal Reserve System has been seeing to it re funds were available to help the banks through the June 15 money pinch.

Bankers noted that their institutions could obtain more replacement CD's if ey were willing to pay the price. The larger banks already are paying the top percent rate permitted under Federal ceilings on CD's maturing as quickly 3 months, in some cases; most banks, however, still aren't paying that maxi-m rate on CD's shorter than 6 months. Bankers say they have no doubt they ld attract more CD funds if they were willing to broaden the top rate to even rter maturities. Some bankers confide, however, that their managements reluctant to do so—not only because of the costs involved, but also due to ssures that have been building in Congress to restrain banks from paying the ximum rate on shorter maturities.

Bankers also noted that their institutions have been getting through the cur-t squeeze by relying increasingly on dollars on deposit in U.S. banks but d by foreigners abroad—the so-called Eurodollars. It's estimated there are rently between $2.5 billion and $3 billion of these European-owned dollars he U.S. banking system.

A factor that has been accentuating the money squeeze for U.S. banks con-ues to be the pressures caused by sales finance companies that compete with banks for short-term investment funds through the sale of commercial paper. erest rates offered on commercial paper have been rising steadily and in ne instances exceed the maximum rates that banks can pay.

Yesterday, still another finance company raised to 5½ percent from 5⅜ per-t its rate on some maturities of commercial paper it issues and places with estors.

Associates Investment Co. said it will pay the 5½ percent on paper maturing 210 to 270 days while continuing its 5⅜ percent rate on 30-to-209-day paper. least three other large finance companies are offering 5½ percent on their Js, with Pacific Finance Corp. quoting that rate on paper maturing as early 30 days. The prevailing rate paid by most companies is 5⅜ percent across board. Several companies are paying 5.40 percent in this range.

Higher rates are currently paid on still another kind of commercial paper—promissory notes of larger industrial corporations and smaller finance com-ies marketed in the open market through dealers. The range on such paper turing in 90 days and from 4 to 6 months is from 5½ percent to 5⅞ percent.

Mr. MARTIN. I haven't seen the article, but as you read it to me lon't think it is accurate. There has been no intention to help any tor of the market in preference to any other sector of the market. ır operations are general and not directed specifically to any seg-nt of the market.

(The chairman subsequently submitted the following statistics:)

[From the Washington Post, June 17, 1966]

FEDERAL RESERVE TABLE

NEW YORK, June 16 (AP)—The Federal Reserve has eased slightly its tight dit policy, reserve statistics released today indicated.

n the week ended yesterday, the Reserve estimated net borrowed reserves of million a day.

t revised downward sharply its estimate for the previous week of net borrow-s from $375 million to $321 million. The corrected figure was substantially

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less than the week ended June 1 when net borrowings reached a 6-year high of $387 million.

[In millions of dollars]

Member bank reserves, reserve bank credit and related items	Averages of daily figures			
	Week ended June 15, 1966	Change from June 8, 1966	Week ended June 16, 1965	Wednesday, June 15, 1966
Reserve Bank Credit:				
U.S. Government securities:				
Bought outright, system account	41,601	−60	+3,074	41,435
Held under repurchase agreements	58	+37	−232	
Acceptances:				
Bought outright	83	+1	+40	83
Held under repurchase agreements	99	−34	+87	99
Discounts and advances:				
Member bank borrowings	788	+241	+177	766
Other	12	−8	−3	12
Float	1,809	+44	+177	1,825
Total, Reserve bank credit	44,450	+220	+3,319	44,220
Gold stock	13,533		−759	13,534
Treasury currency outstanding	5,911	+23	+517	5,924
Total	63,893	+242	+3,076	63,678
Currency in circulation	42,356	+130	+2,801	42,425
Treasury cash holdings	1,018	+26	+247	1,028
Treasury deposits with Federal Reserve banks	909	+172	+93	1,038
Foreign deposits with Federal Reserve banks	136	−10	−15	139
Other deposits with Federal Reserve banks	388	−4	+211	404
Other Federal Reserve accounts (net)	567	−50	−664	491
Total	45,375	+266	+2,673	45,525
Member bank reserves:				
With Federal Reserve banks	18,518	−24	+403	18,153
Currency and coin (estimated)	4,809	+135	+275	4,240
Total reserves held	22,327	+111	+678	22,393
Required reserves (estimated)	21,880	−110	+633	22,071
Excess reserves (estimated)	447	+221	+45	322

Maturity distribution of loans and securities, June 15, 1966 (acceptance and securities held under repurchase agreements are classified as maturing within 15 days in accordance with maximum maturity of the agreements.)

[In millions of dollars]

	Discounts and advances	Acceptances	U.S. Government securities	
			Holdings	Changes during week
Within 15 days	766	113	1,261	+61
16 to 90 days	12	69	10,110	−146
91 days to 1 year	(1)		14,823	+86
Over 1 year to 5 years			13,549	−108
Over 5 years to 10 years			1,307	
Over 10 years			385	
Total	778	182	41,435	−107

[1] Less than $500,000.

The CHAIRMAN. I believe we have enough members here so that we can have some agreement as to the time, if that is satisfactory with the committee.

Now, we have bills pending that the members want to interrogate you about, Mr. Martin.

If I am correct, the members who have not interrogated Mr. Martin of the Federal Reserve Board about their bills are—I have one bill

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that has not been considered—Mr. Weltner, Mr. Reuss, and Mr. Hanna, I believe are the ones that have not had the privilege of interrogating.

I wonder if we could agree on 5 minutes each for these members to interrogate Mr. Martin, and then, at the end of that time, unless there is some compelling reason why we should continue it, then we will go into executive session and make an effort to arrive at some conclusion on this bill.

I think it is very important that we make every effort to pass it before the end of June. And if we don't do it this morning, I suggest that we meet immediately after the House adjourns this afternoon. We will have to be on the floor at 5 minutes to 12 because we have the defense production bill up on the floor today. And it should not take too long.

I believe that we would have time to meet here this afternoon, and I hope that we can meet tomorrow morning if we do not get through with this today. This is very urgent legislation, as all of us realize and know.

Can we agree on this limitation of time?

Mr. MOORHEAD. Mr. Chairman, are you limiting the questions to certain members?

The CHAIRMAN. Yes; the ones who have bills they want to ask Mr. Martin about.

Mr. MOORHEAD. Well, Mr. Chairman, I don't have a bill in, but I certainly would like to have an opportunity to question Mr. Martin about Mr. Reuss' proposal.

The CHAIRMAN. I am not trying to prevent that at all. I am just trying to find out what the feeling was, whether we want to get through or not, and I think we want to get through today if possible.

Mr. MOORHEAD. I am willing to come back after the House adjourns this afternoon.

The CHAIRMAN. After they adjourn?

Mr. MOORHEAD. Yes, sir; and for that purpose you could cut me down to 4 minutes, or for 3 minutes, for that matter.

The CHAIRMAN. In other words, you are suggesting 3 minutes to the members all the way around?

Mr. MOORHEAD. Yes, sir; Mr. Chairman. I think that some of us would certainly be willing to yield part of our time to other members if they needed it.

The CHAIRMAN. Well, we cannot do that under our rules.

If anybody is trying to give the members an opportunity, I believe I am, and I believe I have. I have fought for that ever since I have been a Member of Congress. I feel that every member is entitled to it, but we have had almost unlimited opportunity to ask questions of the Federal Reserve Board and I thought for that reason we might restrict the time today.

What do you think about that, Mr. Fino?

Does that seem all right?

Mr. FINO. That seems all right to me.

The CHAIRMAN. We will all just alternate, with 3 minutes each. We will all have an opportunity of 3 minutes.

Suppose we start with Mr. Barrett.

Mr. BARRETT. Mr. Chairman, I have a question with regard to Mr. Martin's testimony on page 5 of his statement.

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Mr. Martin, you said:

If you fix a rate, rather than leaving it to our discretion, you would face a difficult choice, it seems to me.

Mr. Martin, I want to point out here, we are being avalanched now, by builders of all kinds because of their inability to get money. The starts which we had hoped would move up this year, to close to $2.5 billion, is now running downward. I would like to ask with regard to the several proposals to limit the rate of return on certificates of deposit: What would be the effect of setting a ceiling of 4½ or 4¾ or 5 percent on the economy; and, if it did have a damaging effect, how long would it take you to notice it, so it could be readjusted?

Mr. MARTIN. The length of time, Mr. Barrett——

Mr. BARRETT. I can't hear you.

Mr. MARTIN. I said the length of time of noticing something like that is a difficult thing to state specifically. I would say a minimum of 6 months, probably.

Mr. BARRETT. You would say a minimum of what?

Mr. MARTIN. Six months, a minimum. That would be my guess. It is only a guess.

Mr. BARRETT. That is all I have.

The CHAIRMAN. Mr. Fino.

Mr. FINO. Thank you, Mr. Chairman.

Mr. Martin, do you agree that whatever bill we report will not solve this problem of outflow of funds from thrift accounts?

Mr. MARTIN. In my judgment, it will not because the problem at the moment is that borrowing is exceeding savings, all across the country; and we are overspending and undersaving at the moment.

Mr. FINO. I believe that we are all agreed that CD's have created a serious problem. But haven't we in Congress, by passing the Participation Sales Act, aggravated this problem?

Mr. MARTIN. Passing the Participation Sales Act has put additional pressure on the money market. I wouldn't say that is the only thing that has put the pressure on the money market, but it has aggravated the pressure on the money market, right, Mr. Fino.

Mr. FINO. Thank you

The CHAIRMAN. Mrs. Sullivan.

Mrs. SULLIVAN. Mr. Martin, if the reserve requirement is set, would that affect all of the banks under the Federal Reserve System?

Mr. MARTIN. That is correct, and that is why I introduced in the record this graduated reserve bill which I think ought to apply to all insured banks.

Mrs. SULLIVAN. Some of the banks that are not in the Reserve System have contacted me and they say they feel it would be very harmful to them if there was any reserve set just for those under the Federal Reserve System.

Mr. Martin, I have received letters from a number of commercial banks complaining about the interest-rate war, and particularly about the role of the Federal Reserve Board in starting it.

Now, for the benefit of all of the members present, would you please tell us if you and other members of the Board have received similar letters from commercial banks, particularly the smaller ones?

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Mr. MARTIN. I have received some, Mrs. Sullivan; not a great many.

Mrs. SULLIVAN. In your speech in January to the Life Insurance Association, you suggested that raising the interest rate ceiling to 5½ percent was for the benefit of the smaller banks and not the larger ones. We are all wondering if that has been the actual result.

Mr. MARTIN. I think it has made it possible for many smaller banks to compete that would not have been able to compete otherwise.

Now, it would have been nice if there had not been this surge in demand for funds of an almost overwhelming nature, which has pressured rates up to the 5½ percent level very rapidly. But, if we had kept the rate lower, kept it at 5 percent, for example, I think a good many smaller banks would have been in trouble much sooner than they have been. At least, they have had some discretion in this.

When you get an overwhelming surge of demand for credit such as we have, under conditions of virtually full employment and very little additional available plant capacity, and when the demand for that credit has reached the point where it can only be satisfied by creating new money, then you have a very difficult and inflationary situation to deal with, and that is what we are all working with at the present time.

Mrs. SULLIVAN. The dozen or so banks that I have heard from in my own area in the past few days have told me that they now have almost cut off credit—that they feel the rates are too high and in order to hold down they simply have turned down most requests for loans in this past month.

Mr. MARTIN. I might say here that I hope that over the period of the next couple of weeks, before July 1, that all banks will act responsibly in extensions of credit and not engage in a so-called war.

I think the great majority of banks are acting responsibly, today, and I think the great majority of savings and loan institutions are acting responsibly. But I think they are up against an overwhelming surge of demand for credit that is making it very difficult for them. When we have reached this point in the economy, somebody is going to be pinched, somebody is going to be hurt, somebody is going to get less than he thinks he ought to get, but that is in the interest of keeping inflationary pressures from developing further, which is the interest of all of us.

Mrs. SULLIVAN. You believe it is more a case of increased demand for credit rather than the shifting of funds from one type of institution to another to try to get the highest interest?

Mr. MARTIN. I think we ought to reserve final judgment until after this July 1 period, but I think that some light may be thrown on this by reports of a recent survey by the Bowery Savings Bank that made a check of withdrawals from it. I don't vouch for this, but it pointed out that the great majority of these withdrawals were not to shift to a bank, but they were to go into investments in stock.

I personally have made some checks on this because I am interested in this area and I know that at least 10 people who have made with-

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drawals, 3 from savings and loans, but the other 7 from banks, in order to buy stocks.

Mrs. SULLIVAN. Thank you very much.

The CHAIRMAN. Mr. Reuss.

Mr. REUSS. Thank you, Mr. Chairman.

Chairman Martin, the draft presented on which you commented this morning was prepared with a lot of care by members on both sides of the aisle in an effort to arrive at some solution which would preserve the flexibility and the discretion which the Federal Reserve wants, and at the same time indicate some general guidelines which we believe are in the public interest, and I am sorry that, having read our efforts, you pretty much reject every syllable of it.

You are a little bit like the visitor to the Holy Lands some years ago. He traveled from Dan to Beersheba, and then he said when he was through, "Lo, all is barren."

Mr. MARTIN. Well, sir——

Mr. REUSS. I am particularly disturbed that you don't like the idea that the Federal Reserve should become eligible to purchase Home Loan Bank bonds, particularly since I have just received a letter from Chairman Horne of the Federal Home Loan Bank Board vigorously endorsing this, and expressing general agreement with the whole bill.

As a reason for your position, you state on page 1:

> The impact of such purchases on bank reserves could be neutralized by offsetting sales of direct Treasury obligations, but this would increase the cost of Treasury borrowing.

Now, is it not a fact, Mr. Chairman, that for the last 4 years under Operation Twist, you had been lightening your purchases of Treasury bills, thereby increasing the cost of Treasury borrowings, and that you have not batted an eyelash over this? Isn't that true?

Mr. MARTIN. Yes, that is technically true. But, there we were shifting, of course, between the coupon issues and bills, and now you are getting into a wider sector.

Mr. REUSS. But the aim is to help the homebuilding industry of this Nation, which is now operating at about 9 percent unemployment rate.

Mr. MARTIN. I have already pointed out that the best way that we can see to help that would be the injection of funds into the FNMA operation. I don't believe you are going to solve this problem by a modest adjustment of interest rates that banks may pay. Now, that is a judgment that I make.

Mr. REUSS. You rule out, then, any help to the savings and loan industry, which channels funds to the homebuilding industry?

Mr. MARTIN. I think that——

Mr. REUSS. That is what you say, the purchase of Home Loan Bank bonds would put the savings and loan associations in possession of credit which they could then make available to homebuilders, but you reject this.

Mr. MARTIN. I don't reject it, but I say it has very far-reaching consequences when we start using the open market operations of the Federal Reserve to give special assistance to homebuilding and small business and other activities, because this would create high-power dollars. I think this is a——

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Mr. REUSS. But you then go on to say that to the extent that you matched it by sales of Treasury's, the effect on high-power dollars would be neutralized.

Mr. MARTIN. I think you are picking on a very small point there, Mr. Reuss, if I may say so.

Mr. REUSS. Page 1, the third to the last line, you made the point that it could be neutralized.

Mr. MARTIN. I am only saying we could neutralize it in terms of that particular operation, but there is a much wider principle involved here than that. This is just one little item that I pointed out. We could neutralize. But so far as using the open market operations for any of these instruments, I say it is something that ought to be studied very carefully and we would have to be very cautious about moving in that direction to help any segment of the economy.

Mr. REUSS. I would have one other question.

On page 4, in talking about the sense-of-the-Congress resolution which is made in the draft bill to the Fed, to limit the rate of interest which may be paid on time deposits held by depositors eligible to hold savings deposits to levels "appropriate in the light of rates which may soundly be paid by thrift institutions generally." You shrug that off on page 4 by saying, and I am quoting:

I can understand your position: You are not sure that the Board will use whatever authority you wish to give us to differentiate between the money-market CD's and other time deposits, and you would like some guarantee. But I cannot give you that guarantee.

Here I suggest, Mr. Chairman, you are being quite uncharitable to us on the committee who tried to give you that discretion. That sense-of-Congress resolution gives you the widest discretion to differentiate or not to differentiate, so I don't really think you should brush us off by defiantly saying that you can't give us a guarantee when nobody asked you for a guarantee.

I would hope, however, that we would have a guarantee that if Congress passes this resolution, in the secret chambers of the Federal Open Market Committee, you would at least read it and ponder it before you make your decisions.

Mr. MARTIN. We read and ponder everything this committee suggests, not only in secret chambers but openly, but I did want my position to be perfectly clear.

Mr. REUSS. I hope you would ponder it with gravity.

Mr. MARTIN. We always ponder everything with great gravity.

Mr. REUSS. My time is up. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Brock.

Mr. BROCK. Thank you, Mr. Chairman.

Mr. Martin, if I may quickly summarize your position, you are in favor of increasing FNMA purchasing authority; you are in favor of broadening the reserve requirement range from 3 to 10 percent; you are in favor of the broadened authority to differentiate between types of savings accounts.

Those are the three areas in which you do agree with this proposal?

Mr. MARTIN. That is correct.

Mr. BROCK. The balance, I believe, I am fair in saying, you do not favor?

Mr. MARTIN. That is correct.

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Mr. BROCK. The sense-of-Congress elements, the elements authorizing the purchase of Federal Home Loan Bank bonds, and FNMA participation?

Mr. MARTIN. That is right.

Mr. BROCK. Now, Mr. Martin, would you gage for me the relative impact that the limitation of long-term Federal debt has had on the money market as contrasted with the effect of $17-plus billion of CD's have had on the money market? In other words, the point I would make, it seems to me that by putting an unrealistic limit on long-term debt of 4¼ percent ceiling, you force the Federal Government into the short-term money market; thereby placing more pressure on the market than you do by the purchase of the $17 billion of CD's, is that about right?

Mr. MARTIN. In my judgment, that is a fair statement.

Mr. BROCK. Would we be more honest with ourselves if we took a very serious look at the limitation on the long-term debt ceiling or interest ceiling?

Mr. MARTIN. I think we would; and I have so testified on several occasions.

Mr. BROCK. Thank you, very much.

The CHAIRMAN. Mr. Moorhead.

Mr. MOORHEAD. Thank you, Mr. Chairman.

Mr. Martin, recently there have been certificates of deposit issued abroad. There are different competitive areas over there. If the Reuss proposal were enacted, would we be safe in continuing these CD's, or, in other words, under this proposal, could we have a different rate for European CD's?

Mr. MARTIN. I think you could.

Mr. MOORHEAD. Mr. Martin, would you favor an amendment which would delete the word "large" from in front of "negotiable certificates of deposit" in the Reuss proposal? I understand you oppose it in your testimony so presumably you think this would improve the legislation?

Mr. MARTIN. Yes, I think that would be better.

I want to make my position clear on this, that I find it very difficult to justify discrimination between large and small deposits, and I find it particularly difficult to agree to proposals to allow banks to do anything they want with the large amounts.

Mr. MOORHEAD. Mr. Martin, can you see a distinction between passbook savings accounts and other time deposits?

Mr. MARTIN. Yes, there is one now, and I think it should be enforced.

Mr. MOORHEAD. Now, if we enacted the Reuss proposal, and I might say that the majority of the committee are working that way, if we enact it, do you see in the area of reserve requirements, would you favor a different reserve requirement for the passbook type of savings account than other time deposits?

First, on reserve requirements?

Mr. MARTIN. Well, I don't think the member banks ought to be put at a disadvantage with the nonmember banks, but if you give us this authority, and that is the reason I propose in this graduated bill to apply reserve requirements to everybody. Otherwise, if you grant us broadened authority on reserve requirements and we exercised it for members, it wouldn't apply to nonmembers.

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Mr. MOORHEAD. That is the case today, without this legislation?

Mr. MARTIN. That is correct, but I see no reason to make that worse.

Mr. MOORHEAD. Would I be correct that unless we made the language of the bill stronger, even though we gave you the range of 3 to 10 percent, which you say is agreeable to the Board, you would not use that authority to make any difference between savings accounts deposits and other time deposits?

Mr. MARTIN. Well, I would think we would want to consider it very carefully.

Mr. MOORHEAD. I think my time has expired. Thank you very much.

The CHAIRMAN. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

Mr. Chairman, we are under the 3-minute rule, and to me this is like a State Department briefing, it is an exercise in futility. And so we get into semantics and whatnot.

I personally feel, and I will use this portion of my minutes to say that you, Mr. Martin, have helped to federalize the loan sharks in our country. I think the overall general interest of the people has been forgotten or overlooked. I think Congress has contributed to it. That is why I say, advisedly, that you all have only helped to nationalize the loan sharks. So I look with considerable interest on all of these proceedings. I think the damage has already been done. I think that the day of reckoning inevitably comes, and we will just have to wait for that.

I really don't see any point in asking any questions at this point, but just go into executive session and do something on the bill, but I didn't see much reason in calling Mr. Martin back to begin with.

The CHAIRMAN. Mr. Clawson.

Mr. CLAWSON. Thank you, Mr. Chairman.

Chairman Martin, the questions that I have, I think are interwoven and related to our overall problem which we are considering right at this moment.

To what extent has the administration used fiscal policy to correct the inflationary spiral as related to monetary policy as a corrective measure?

Mr. MARTIN. As I have indicated on several occasions, I think we have relied far too heavily on monetary policy, and I think we have been wrestling with a full employment budget deficit which calls for fiscal policy rather than monetary policy for correction. So, my answer to your question is, We have been relying too heavily on monetary policy.

Mr. CLAWSON. In the light of mounting balance-of-payments deficits and the increase in interest rates throughout Europe, are we not running the risk of increasing the burden of further monetary action in order to meet this international situation, unless we take some kind of fiscal action?

Mr. MARTIN. Well, having been abroad recently and talked to a good many people, I think that we have had—and Secretary Fowler has been wrestling with a very difficult problem here—we have had a balance-of-payments deterioration recently and I believe that Vietnam is the principal culprit. With the inflationary pressures here at home, we are trying to do too much too fast, and we will either have to reduce

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expenditures or increase taxes, or both, if we are going to get things on an even keel again.

Mr. CLAWSON. If we fail to do this, will there be an increase in regulation Q?

Mr. MARTIN. I would hope that regulation Q would not be raised. I wouldn't want to make a commitment that it would not be. I don't like to see rates ratcheting up all the time. I don't say that the Board won't raise regulation Q, but it would be my hope that regulation Q is at its high.

Mr. CLAWSON. In view of the deficit problem, it is a risk——

Mr. MARTIN. There is a real problem where you are relying on monetary policy alone, as long as the surge of borrowing demand is as large as it is in the country at the present time, and with full employment and plants running at over 92 percent of capacity there is a risk that something more will have to be done on monetary policy than has been done, Mr. Clawson.

Mr. CLAWSON. Thank you.

The CHAIRMAN. Mr. Weltner.

Mr. WELTNER. Thank you, Mr. Chairman.

Mr. Martin, on page 4 of the statement you say you cannot give this committee any assurance that the Board will take any action of any kind; and that it is a mistake for an administrative agency to make any commitment; that it is a mistake for us to compel the Board to act; and that if we want to act, we should be prepared to take that responsibility ourselves.

Then you go ahead and say that if the committee desires some specific assurance that what we need to do is to pass a bill such as the bill of Mr. Hanna or myself. Is that a fair summary of your statement?

Mr. MARTIN. That is correct.

Mr. WELTNER. So you are saying that if this committee wants anything, it has better do it itself and not rely on any sense of Congress resolution.

Mr. MARTIN. That is correct.

Mr. WELTNER. Thank you, sir.

The CHAIRMAN. Mr. Hanna.

Mr. HANNA. Thank you, Mr. Chairman.

Mr. Martin, I think, looking back over 15 years, it is fairly clear that when the crisis in our economy occurs that requires the action of your Board, the net effect of your action is to place the burden of the state of economy upon the mortgage dependent portions of the economy.

It occurs to me that a monetary policy which does not take into consideration a balance between both the short-term and long-term money markets is not sound policy.

It appears to me that it is in fact a policy which is placing an unreasonable burden, as you stated, somebody has to feel the pinch. It appears to me that this somebody always turns out to be the same person, and I feel that these persons, just like the Englishman I talked about in this committee sometime ago, they have the right to stand up and say, "I say, Ol' Boy, will you wave it about a bit, I seem to be getting the brunt."

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And I think in adopting the twist, which was referred to by Mr. Reuss, you have already indicated that you see a sense of responsibility of balancing these two markets, and I suggest to you that the request of the legislation that is before you, urging that you do these things, cooperate more in the choices and decisions you have made with the Home Loan Bank Board and those other elements that are trying to balance the economy, to be responsible with the open market operation for the obligations of the Home Loan Bank Board and FNMA, not because we want to put you in a binding obligation with other agencies, but because we want you to be responsible for a balanced monetary policy that looks at the mortgage long-term situation, for those dependent on the mortgage market in our economy.

Now, that is what we are asking, along with taking the responsibility that my colleague from Georgia indicated, setting it right ourselves; I am ready to take that responsibility as my bill indicates.

I would like to have your comments on the responsible balance monetary policy.

Mr. MARTIN. We have always taken into account a responsible balance, Mr. Hanna. There is a matter of judgment of this, but when restrictive policies are employed some sector of the economy has to suffer.

Now, housing has been favored in many respects; that is why we have FNMA, along with a great many other assists to the housing market. Homebuilding has been something that has been favored.

Now, as I have indicated in response to another question, I think we would be on a much sounder basis if we had been using fiscal policy since the early part of this year. I think the situation called for an increase in taxes. We haven't had it. It has now gotten rather late in that area. There are many reasons why perhaps that should not be done, but that is not my area. But in the monetary area, we have not at any time been insensitive to the requirements of housing and homebuilders and the mortgage market, but there is a limit to supplying money when the demand for credit so far exceeds the savings that are currently available. Otherwise you would be calling upon the central bank to just create the money to meet all demands.

Mr. HANNA. Mr. Chairman, I am not suggesting to Mr. Martin that he do something beyond his capability, but what I am suggesting is, that if monetary policy is used, and granting, Mr. Martin, that you are not going to be able to solve this solely within the powers and discretions that you are responsible for, but to the degree that you do not utilize that, it seems to me we are going to have to require that there is a more balanced consideration for where the impact of your monetary policy is going to strike, because in 1951 and 1952, it hit the mortgage market; in 1957 and 1958, it hit the mortgage market; in 1965 and 1966 it hit the mortgage market.

I suggest that regardless of how much finger-pointing there can be to other segments, you cannot avoid the demonstrative fact that the utilization of the powers that you hold, if you continue to employ them as you have applied them, will give us exactly the same answer every time.

I yield back any time I may have, Mr. Chairman.

The CHAIRMAN. Mr. Johnson.

Mr. JOHNSON. Thank you, Mr. Chairman.

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Mr. Martin, I am one who believes in having a strong and independent Federal Reserve Board, and I am a strong believer in the dual banking system, and I want to say that I listened to all the witnesses here about the certificate of deposit crisis, so-called.

It has been apparent that issuing negotiable certificates of deposit is a legitimate banking function, and it was testified here that the $17 billion that the banks have issued, and outstanding in CD's, has been well invested in the best interest of the Nation, but granted, yes, it is drying up funds to the savings and loan associations; personally, I don't think what we are going to do here today, to do violence to the CD market, is going to help the savings and loans at all. We must do something to help them directly.

So, I am interested in what you had to say on the first page here. You think injecting funds directly into the mortgage market is the best way to help the crisis that we face in the savings and loans, where they are saying that they must have market money to finance new homes. Should we organize a reconstruction finance corporation for housing, or something, to face that crisis, rather than doing violence to a legitimate banking function, and that is the issuance of certificates of deposit?

Would you answer that question, what could we do to help the savings and loans now without passing the restrictive proposals that are before us?

Mr. Martin. Well, the Home Loan Bank Board, Mr. Johnson, does have this under its wing, and it can be helpful in the area, and it has been. I know they are doing everything they can.

And as I have already indicated, I think that if you want to help housing directly, an increase in FNMA's authorization is desirable.

Mr. Johnson. Do I understand that this Hanna bill would authorize the Federal Reserve Board to purchase up to $5 billion worth of obligations of the Home Loan Bank Board, and so forth, so that you would be injected into the situation?

Mr. Martin. I think that is what the intention is.

Mr. Johnson. If you had $5 billion right now, authorized to spend, would you go to the open market and buy up a good number of these securities which would free money to go into the savings and loan?

Mr. Martin. I definitely would not. I won't say that there may not be a later period in which I would want to consider this, but at the present time, on the basis of all of the evidence I personally have been able to accumulate, I would not want the Federal Reserve to go into the market to purchase these securities.

Mr. Johnson. Then we would be doing a vain thing if we passed this bill today, giving you this $5 billion authority——

Mr. Martin. Well, if the Congress directs us to do this, as I have indicated, we will carry out whatever the Congress legislates. There has never been any question about that at any time, as Mr. Patman well knows. Whatever law you pass here, we will do our best to carry it out, Mr. Chairman.

The Chairman. If the law directs you to do it, that is your point?

Mr. Martin. That is correct.

The Chairman. That is right. That is just what I am going to try to do.

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Mr. MARTIN. There is no misunderstanding on that point at any time.

The CHAIRMAN. Have you finished, Mr. Johnson?

Mr. JOHNSON. My time is up. Thank you.

The CHAIRMAN. Mr. Todd.

Mr. TODD. Thank you, Mr. Chairman.

Mr. Martin, sometimes I feel a little lonely in advocating a tax increase, and I must confess that I appreciate your response to Mr. Clawson's and Mr. Hanna's questions on this particular matter.

I take it that, given the level of congressional appropriations, you would feel a tax increase would be appropriate at this time?

Mr. MARTIN. I do.

Mr. TODD. Thank you very much.

I tend to share that view, and I have been so saying in my district, rather loudly.

Could I ask you, is your rather dim view of the Reuss proposal shared by other members of the Board?

Mr. MARTIN. Yes; I think so. I cannot speak for them, individually, today, but I think I am fairly representative in what I am saying.

Mr. TODD. Then, I have one further question, and perhaps, for your information, I can just give you that (passing paper to witness).

The question is this, what would your opinion be relative to the following proposals:

Establish for 1 year a maximum interest of 5 percent on CD's in denominations of less than $100,000?

Make CD's issuable in minimum amounts of $1,000?

Make a minimum maturity for 1 year with quarterly interest payable?

A 90-day notice of redemption with passbook interest rate payable on CD's redeemed before maturity?

Mr. MARTIN. Well, all of these suggestions have been actively considered by our Board and have also been discussed within the System. And I think all of them, under certain conditions which we do not think have yet arrived, might be desirable.

Mr. Partee points out that the minimum maturity of 1 year on negotiable CD's would be quite bad, and that I agree with. I had not noticed that. Quarterly interests on negotiable CD's would make them quite difficult to sell in the market.

But I think these proposals have merit as possible tools to be used under certain circumstances. I don't think those circumstances exist at the moment.

Mr. BROCK. Would the gentleman yield for a question at this point?

Mr. TODD. I yield.

Mr. BROCK. Do you not have the authority to put these into effect now, under the present authority of the Board?

Mr. MARTIN. I think we have on all of these.

Mr. TODD. You are not in position to differentiate on these as yet——

Mr. MARTIN. With the exception of the amount, that is correct.

Mr. BROCK. With the exception of the dollar amount?

Mr. MARTIN. The size.

Mr. BROCK. You do have the ability to change maturity and interest rates?

Mr. MARTIN. That's right.

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Mr. BROCK. This would require no new legislation except in the area of amount?

Mr. MARTIN. Except for size, that is correct.

Mr. TODD. Thank you very much.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. I overlooked one.

Mr. McGrath is next, excuse me.

Mr. MCGRATH. Thank you, Mr. Chairman.

Mr. Martin, is the level of savings in the savings and loans of the country higher today than it was last year?

Mr. MARTIN. Mr. Partee says it is.

Mr. MCGRATH. The rate of growth decelerated?

Mr. MARTIN. That is right.

Mr. MCGRATH. I have seen figures that American corporations intend to invest in new plants and equipment in 1966 at the rate of about 17 percent over what they did in 1965. Is that a significant factor in this excessive borrowing you were talking about this morning?

Mr. MARTIN. No question about it. One of the problems in that regard until recently was that they were going to the bank sometimes for term loans that, in my judgment, should have been in the capital market, but I think that has pretty well stopped.

Mr. MCGRATH. That is all. Thank you.

Mr. HANNA. Will the gentleman yield?

Mr. MCGRATH. Certainly.

Mr. HANNA. I think the gentleman is making an excellent point, and I would have further commented on the report that has come out recently from the Joint Economic Committee, and that would indicate to us that the level of savings of the American people is holding rather constant. It is now between $25 and $30 billion, at an annual rate. The increase in the loans that the gentleman talked about is about $10 billion in this segment. The consumer debt is slightly below what it was in January of 1965. The mortgage debt is only $1 million different than it was in 1965, which indicates to me that it isn't the people, it isn't the people or their consumer activities that is creating this problem, and yet it seems to me that they are the ones that are going to pick up the tab for the problem that has been created.

I thank the gentleman for making that point so clear.

Mr. MARTIN. If there is a rise in prices, it is the people that will pick up the tab, too.

Mr. HANNA. That is what I said.

The CHAIRMAN. Including interest rates.

Mr. Stanton?

Mr. STANTON. Thank you.

Mr. Martin, going back to your statement of the difficulties of our country at the present time, due to overspending and undersaving, did you limit that statement to the private sector, or did you mean the public sector as well? Don't you think that at the top of the overspending and undersaving is the Federal Government itself?

Mr. MARTIN. I think we are trying to do too much too fast in both the public and private sector at the moment.

Mr. STANTON. This committee has heard that due to the outflow of money that took place last April in the savings and loans we are all fearful of what will happen in July.

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Is it not true that with this hot money we have never been able to determine whether the large part went into CD's, some went into the stock market, some, because of changes in regulations in the tax laws; isn't it a possibility that this hot money that is going back and forth around the country may now settle down, and maybe the crisis in July will not be quite as bad as all of us think it may be?

Do you have any thoughts on that?

Mr. MARTIN. I am very cautious about this. We haven't helped matters any by discussing it so violently. I have had several people come to me and say—I am going to take my money out because everybody is talking about July 1. That doesn't help.

But let me point out that you have over this period a remarkable growth in the economy, and it is continuing. Some people talk about this pause and this letdown in the economy. Well, we will give out this afternoon our production index for the month of May and it will be up 1.2 percent. This is the month of May.

Now, we have had some cooling off in automobiles and in housing, but we are in a period of unparalleled prosperity in this country at the present time and we ought not to lose sight of that or to forget it.

I think on that basis that we know that the demand for credit is going to, is likely to, continue until there is some slowdown more marked than we have had evidence of. I am not seeking a slowdown. I am talking about what it would have been if we had not kept some pressure on this current market.

Mr. STANTON. One last question. In the question of the balance of payments, do you think that because we failed to use our fiscal tools earlier this year, that whatever initiatives we had when we changed regulation Q in December, in the light also of increased interest rates in Europe, that we have lost perhaps whatever initiative we had at that time, as far as the balance of payments is concerned?

Mr. MARTIN. No. I would not go that far, but it has not helped the situation.

Mr. STANTON. Thank you. My time is up.

The CHAIRMAN. Mr. Hansen.

Mr. HANSEN. Thank you, Mr. Chairman.

Is it true, Mr. Martin, that the increase in the interest rates came about as an effort to cool down the economy?

Mr. MARTIN. That is correct.

Mr. HANSEN. And is it true, too, as Mr. Hanna pointed out, that the brunt of it hit the homebuilding industry the hardest?

Mr. MARTIN. It certainly has its major manifestations there at the present time. I think there are other factors besides just interest rates in the housing picture, because I think the cost of building houses is a factor, and I also think——

Mr. HANSEN. Including the interest rate?

Mr. MARTIN. Including interest cost, to be sure, but it is a very modest cost as against the others.

Mr. HANSEN. Isn't it true, too, that these discussions are aimed at an effort to remove the bind or difficulty in which the homebuilding industry finds itself, and its related industries, as a result of all of this?

Mr. MARTIN. No; I do not believe the problem in housing can be solved by lowering regulation Q ceilings.

Mr. HANSEN. The next point I want to get at, is it true, too, that the suggestion that there be a tax increase would bring about a leavening

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of this tight situation, and if it did have the effect that everyone says it would, would we not be back here trying to figure out some way to remove the difficulty that that in itself has then created?

Mr. MARTIN. Well, we are always going to be beset with difficulties, Mr. Hansen, I agree with you on that.

Mr. HANSEN. I am inclined to agree, to an extent, with what Mr. Hanna and Mr. Weltner said, that there should be some means taken to bring about an averaging on this matter so that these problems are not faced entirely by the savings and loan industry.

Mr. MARTIN. I don't think these problems are.

Mr. HANSEN. You have rejected each of those. Now, do you have a suggestion to make that would take care of this problem?

Mr. MARTIN. My only suggestion has been the FNMA injection of credit, but I still think that we have not yet learned in this country to deal with the economics of full employment, and this is going to be a major problem for the next few years.

Mr. HANSEN. Pardon me; go ahead.

Mr. MARTIN. I was only going to say that we have not yet devised the tools or means of maintaining stability in this full employment situation, and our foreign friends have gone through it longer than we have and they are looking askance at us at the moment.

Mr. HANSEN. One other point. Figures that I have seen lately indicate that consumer credit has been rising at an extremely rapid rate, I believe somewhere between $77 billion to a rate of, what is it now, $88 billion this year?

Mr. MARTIN. I can give you the figure in just a second.

It is $88 billion.

Mr. HANSEN. As I have analyzed it, that is a more rapid rate of growth than the growth of the gross annual product, and if that be the case, wouldn't it be well to take a look at this also?

Mr. MARTIN. We are looking at that all the time.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Martin, do you believe that a minimum maturity on a time deposit of 30 days is sufficient, first to avoid violating the law against the payment of interest on demand deposits; second, to avoid circumventing the 4-percent interest rate ceiling on savings accounts; third, to avoid the prohibition against corporate savings accounts?

Mr. MARTIN. As I pointed out, where people compute the interest on a daily basis, it would be difficult to put the 30-day maturity in, but we have wrestled with this for a long time, and in late 1964 we reduced the maturity. We can change this at any time. We are studying this all the time right now, and there has been a tendency for maturities to shift, but I think there is still a basic difference between passbook savings and time deposits, and that difference should be maintained.

Mr. ANNUNZIO. Thank you, Mr. Martin.

No further questions, Mr. Chairman.

The CHAIRMAN. Mr. Mize.

Mr. MIZE. Mr. Martin, as you pointed out, the trouble today or last December was that too many people tried to buy too much too fast, and especially the Federal Government.

It seems to me that if the rediscount rate and the limit on regulation Q had been kept at the 4 percent last September, rather than

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going up to 5½, it would have prevented banks from attracting additional funds to make additional loans, and I can't for the life of me see why you felt you were going to put a damper on the inflationary pressure by what you did. I just can't see it.

Mr. MARTIN. Well, I am sorry, Mr. Mize, but I don't know any other way that we could have dealt with that situation. We had had a damming up for a long time of the money stream, as I like to express it, and we had to free it.

Mr. MIZE. But customers needed more money and they were going to the banks and asking for more money, and the banks didn't have the money to make the loans, so you gave them permission to go out and pay 5½ percent for the hot money or cold money, or whatever you want to call it, so they could make more loans. If you hadn't done anything, wouldn't that in itself have kept things moving?

Mr. MARTIN. We don't want the economy to come to a halt, and we wanted to let as many savings as could be attracted come into both savings and loans and banking institutions and others, to be used for the benefit of the economy. If we had just tried to throttle the economy, that would have been another thing.

Mr. MIZE. Now, you would not have throttled it. You just should not have done anything it seems to me.

Mr. MARTIN. We just should have sat by?

Mr. MIZE. Yes.

Mr. MARTIN. I disagree.

The CHAIRMAN. Mr. Rees.

Mr. REES. Thank you, Mr. Chairman.

Mr. Chairman, I would like to read two statements into the record on the mortgage money situation that has been developing in my own State of California.

Concerning the statement that the savings and loan industry had more savings now than they did a year ago—I would like to quote from a recent report to Governor Brown from his savings and loan task force.

> From March 27, 1966, through May 31, 1966, California associations had a net savings loss in excess of $800 million.
>
> The comparative figures for the same period for 1965 shows that California associations had a net savings gain of approximately $400 million.

In terms of the effect on the construction industry, and I again quote:

> The most indicative figure relates to new loan commitments made in April and May, total loan commitments made in April of this year were down 54.3 percent from April 1965, while in May they were down 75 percent from May of 1965.

I would now like to ask a question of Mr. Martin.

Mr. Martin, during the testimony we had, Mr. Horne and also Mr. Saxon, both stated that they were not warned in advance before your decision on December 6 concerning regulation Q. Mr. Saxon is Comptroller of the Currency, and Mr. Horne is head of the Home Loan Bank Board. These are two interrelated agencies, in terms of monetary policy.

Do you think that perhaps there might be or it might have been a good thing, in terms of public policy, to have a statutory board that looks at overall monetary policy instead of allowing one board to

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make a unilateral decision which, as you know, very drastically affected the other agencies involved?

Mr. MARTIN. No; I don't think it would be desirable to have such a statutory board, but I agree that we ought to be better coordinated or have better coordination than we have had.

Mr. REES. Was there any effort, in terms of the Federal Reserve Board decision, to bring in Mr. Horne and Mr. Saxon as both of their agencies of course would be directly affected by your decision?

Mr. MARTIN. There was, indeed, and this I have already testified, and there was a deficiency on my part that they were not brought in. This was a very difficult period and I make no bones about it. I wish they had been consulted. It would not have changed the decision, but it would have given them prior notice.

Mr. REES. Thank you very much. That is all.

The CHAIRMAN. Let's see, now. Is there anyone who has not asked Mr. Martin questions this morning?

How much time do you want, Mr. St Germain?

Mr. ST GERMAIN. Mr. Martin, as you know, we have had a great deal of testimony from different institutions stating in fact that they are in trouble at this point. On the other hand, I heard you mention, in answer to an analysis of the suggestion by Mr. Todd, you stated that the Board had been studying this, and it was felt that there were certain conditions that might warrant the action suggested by my colleague, Mr. Todd, which had not come about. So, I ask you, do you feel that the complaints of the thrift institutions are justified, and secondly, what are the certain conditions that you have been telling us about throughout the morning?

Mr. MARTIN. On your first question, I don't know whether they are warranted or not. I have been trying my best to find out. I think that there is no question, let me just put it to you this way: I have a good many friends in both groups. I had a savings and loan man tell me just the day before yesterday that he had been moving far too rapidly and doing things that he knew had been unwise for some time, and he said, "I am in trouble now," and he said, "I want help and I don't want you to bail me out in such a way that we are not spanked for what we have been doing."

Now, this is a fellow who is owning up honestly to the fact that all of us make errors of judgment.

Now, you say what are the conditions that would warrant us doing this thing. This would be a real rate war, in which savings were not moving into other investments, as I think a great many of them are today, but were moving from one financial institution to another merely for a better rate.

Now, this is a condition that I don't think has as yet been arrived at, but I think that it is possible over the next few months we may see such a situation. I want to emphasize again that the saver, if I may use the phrase, the saver is the forgotten man frequently in all this. The borrower and the lender get all sorts of attention, but the poor saver is just left out on a limb.

Mr. ST GERMAIN. Isn't the saver the borrower also?

Mr. MARTIN. Not necessarily.

Mr. ST GERMAIN. When you were describing this friend in the savings and loan who said he deserved a spanking, I am just hoping

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that the Board will soon determine whether or not the complaints of the thrift institutions are or are not justified.

The CHAIRMAN. It was our understanding, I believe, after we had heard from Mr. Martin, that we resume our executive session.

Is there any objection to resuming the executive session?

(No response.)

The CHAIRMAN. If not, we will resume our executive session.

Thank you very much, Mr. Martin, for your appearance here this morning.

Mr. REUSS. Mr. Chairman, I have a letter of the legislative proposal made by the Federal Home Loan Bank Board, dated June 15, 1966, and one by the United States Savings & Loan League, dated today——

The CHAIRMAN. Do you want that in before we go into executive session?

Mr. REUSS. I would like to have it submitted for the record here.

I have asked unanimous consent to introduce into the record the letters just received from the Federal Home Loan Bank Board, dated June 15, and from the United States Savings & Loan League, dated June 16, on a legislative program.

The CHAIRMAN. Without objection, so ordered.

(The letters referred to follow:)

FEDERAL HOME LOAN BANK BOARD,
Washington, D.C., June 15, 1966.

Hon. HENRY S. REUSS,
Member of Congress,
Washington, D.C.

DEAR CONGRESSMAN REUSS: Pursuant to your oral request, the Federal Home Loan Bank Board hereby submits its views as to the draft bill dated June 14, 1966, for a bill to "secure proper coordination of the Nation's credit resources with respect to the various types of financial institutions, to the needs of the housing industry, and to the prevention of unsound uses of credit".

We believe that a judicious exercise by the Board of Governors of the Federal Reserve System and the Board of Directors of the Federal Deposit Insurance Corporation of the functions which they would have under the bill to regulate rates of interest (and, in the case of the Federal Deposit Insurance Corporation, the rates of dividends) that may be paid on non-demand deposits in member banks of the Federal Reserve System and in nonmember insured banks could afford substantial relief from the difficulties now facing those financial intermediaries which specialize in the field of housing credit. We believe that the purposes of section 1 could be more fully achieved if the Federal Deposit Insurance Corporation were covered by that section as to all its insured institutions.

You can be assured that it is the intention of the Federal Home Loan Bank Board to proceed in good faith and in step with the banking agencies in carrying out the purposes of section 1 in the event of the expression of the sense of the Congress as set forth in that section. However, we call attention to the fact that, while the Board has under section 5(a) of the Home Owners' Loan Act of 1933 a broad regulatory authority as to Federal savings and loan associations which would authorize the Board to regulate the rates of return paid by such associations, this authority does not extend to institutions which are insured by the Federal Savings and Loan Insurance Corporation but are not Federal savings and loan associations. We would suggest, therefore, that a provision such as the following be included in the proposed bill:

"SEC. —. Subsection (b) of section 403 of the National Housing Act is amended by adding thereto at the end thereof the following new sentence: 'The Corporation is authorized from time to time by regulation to impose such restrictions, limitations, and prohibitions on the payment of dividends, interest, or other return on shares, certificates, or deposits in insured institutions, and for the purposes of this sentence to make such classifications, definitions, and exceptions, as it determines to be advisable in the public interest.' "

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The Board is in favor of the enactment of the provisions of section 6 relating to open-market purchases of Federal Home Loan Bank obligations by Federal Reserve Banks.

We believe that the bill could be improved by technical amendments as set forth in the attachment hereto.

Limitations of time have not permitted the ascertainment of the relationship of the proposed legislation or of this report to the program of the President.

With kind regards, I am

Sincerely yours,

JOHN E. HORNE, *Chairman.*

Attachment.

ATTACHMENT TO LETTER DATED JUNE 15, 1966, FROM JOHN E. HORNE, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD, TO HON. HENRY S. REUSS, MEMBER OF CONGRESS

The Federal Home Loan Bank Board notes that some of the terminology in subsections (b) and (c) of section 1 of the draft bill which is the subject of the subject letter is less appropriate in the case of savings and loan associations than in the case of banks. The following amendments are therefore suggested:

Page 4, line 12, strike out "deposits" and insert "accounts".

Page 4, lines 15 through 17, strike out "interest on time accounts held less than ninety-one days and savings accounts held less than thirty days" and insert "dividends or interest on accounts held less than thirty days".

Page 4, line 18, strike out "interest on time" and insert "dividends or interest on".

Page 4, line 24, strike out "or accounts" and insert "in banks or on accounts in savings and loan associations or similar institutions".

In addition, in order that the term "agency" as used in subsection (c) of section 1 may be defined, and in order that no agency could deter changes in regulations by simply withholding its written views, the following further amendments are suggested:

Page 5, line 2, strike out "and obtain the written views of" and insert "with".

Page 5, line 5, after the period, insert the following new sentence: "As used in this subsection, the term 'agency' means the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board."

June 15, 1966.

UNITED STATES SAVINGS AND LOAN LEAGUE,
Washington, D.C., June 16, 1966.

Hon. HENRY S. REUSS,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN REUSS: Attached is a memorandum concerning the latest thinking of the U.S. Savings and Loan League on the CD question. Of course, we have not yet heard Chairman Martin's final testimony.

As you can see we are quite skeptical that the Federal Reserve will take emphatic enough action to accomplish significant results.

But, of course, our attitude is no reflection on your resolution and certainly it is appropriate that the committee first explore what can be accomplished by the simple discretionary route. We want to compliment you for drafting this legislation because it is important that *some* proposal start moving through the legislative channels. There is always opportunity for amendment along the way.

Sincerely,

STEPHEN SLIPHER,
Legislative Director.

MEMORANDUM ON CD SITUATION

There is apparently complete agreement in the Congress, the Federal agencies, and the trade groups that the present diversion of funds from mortgage lending institutions is too severe and will result in an intolerable reduction in the flow of mortgage credit. It is appropriate to comment on some of the many proposals for corrective action.

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The proposed raising of the reserve requirement is well intended but would have nominal and delayed impact on the situation. The proposed minimum maturity of 90 days would have very little effect on the principal type of certificates which are competing for savings. Almost all of the consumer CDs are 90 days or six months and a 90 day minimum would be rather meaningless. *A 5% ceiling on CDs of $100,000 and less would forestall what appears to be a brand new movement about 5% and thus deter an even more catastrophic situation, but it would provide no remedy for the already hectic competition.* As a practical matter, it is the 5%, three and six month CD that now is pulling money out of savings and loan associations. To set a ceiling at 5% would merely perpetuate the status quo and insure a continuance of the drain on thrift institutions. *Actually, a 5% ceiling would probably induce many banks paying 4½% and 4¾% to increase to 5%.*

Currently, the national dividend average for savings and loan associations is about 4½% with many paying lower rates.

It is important to remember that banks, with their checking accounts and other services, have a built-in advantage over specialized thrift institutions. Yet. the Federal Reserve apparently proposes to give the banks as good a savings plan or a little better than that which is offered by savings and loans. The exception is California where associations are going to be permitted to pay 5% on all money.

The only realistic way to check the drain from savings and loan associations is to provide a temporary statutory CD ceiling of 4½% on the consumer type CDs. (The discussion is centered around $100,000. We would have no objection to a lower floor and leaving everything over that floor free of rate control—or the distinction could be drawn between corporations vs. individuals.) Savings and loan associations cannot pay (even on a bonus account) enough more than 4½% actually to draw the money from the banks, but at the same time, a 4½% ceiling on bank CDs would probably retard the withdrawal of savings from savings and loans into banks.

As for the argument against rigidity of rates, such a statutory ceiling would not be permanent and need be applicable only for a year or two—just long enough to make sure the drain is checked and the situation is stabilized. Authority could be returned to the Federal Reserve next year to make whatever adjustments might be deemed necessary on the basis of the experience in the second half of 1966.

No matter how sincere and dedicated the members of the Federal Reserve Board, it is unrealistic to expect them to be truly detached in setting terms of competition between banks and savings and loans. It is also a fact that the Federal Reserve Board in the past has grossly underestimated the extent to which banks would aggressively promote savings to the extent permissible under the rules.

There has been no mention of it in the press, but the Reuss resolution includes dividend controls on savings and loan associations. It would be ironic if legislation designed to help the savings and loan business would impose a control which Congress has in the part refused to grant and which the savings and loan business has opposed for decades. We are perfectly willing to justify our opposition to rate control, but this subjection has no place at all in emergency legislation which must be enacted within the next few weeks to be effective.

Obviously, if we are going to talk about rate controls on savings and loans, we must explore the whole subject of equalizing our lending and investment powers with banks. As an example of the complication involved in such a proposal, similar controls would also have to be imposed on savings banks and no hearings have been held on this question. Regardless of the merits, the fact is that banks have operated under rate controls for 30 years and savings and loan associations have not been controlled. This situation should not be reversed in an emergency bill without hearings. In the Reuss resolution, Section 1(b)(1) merely confirms what is already a fact and thus is not particularly objectionable, but paragraph (2) would give dividend control to the Board and that is the section which we strongly feel should be deleted.

If only the token actions which we anticipate from the Federal Reserve under the Reuss resolution are taken, the savings and loan business will still manage to survive, particularly if the plan to have the Federal Reserve advance funds to the Federal Home Loan Bank System is approved. The Committee should be aware, however, that as far as the housing situation is concerned, the modest proposals being discussed will fall far short of providing the type of correction being sought by the housing experts in and out of Congress.

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SAVINGS GAINS FIRST FOUR MONTHS 1966 COMPARED TO 1965

(Savings and loans, commercial banks, mutual savings banks)

Net savings gains, all savings and loans

[In millions]

1966		1965	
End of December 1965	$110,271	End of December 1964	$101,887
End of January 1966	110,194	End of January 1965	102,141
End of February 1966	110,722	End of February 1965	102,720
End of March 1966	111,560	End of March 1965	103,775
End of April 1966	110,812	End of April 1965	103,682
Net increase	541	Net increase	1,795

Net savings gains, insured savings and loans (differs slightly from above figures which includes uninsured associations)

[In millions]

1966		1965	
January 1966	—$42	January 1965	$244
February 1966	514	February 1965	567
March 1966	820	March 1965	1,044
April 1966	—744	April 1965	—99
Net increase	548	Net increase	1,756

Mutual savings banks

[In millions]

1966		1965	
End of December 1965	$52,600	End of December 1964	$48,849
End of January 1966	52,800	End of January 1965	49,222
End of February 1966	53,000	End of February 1965	49,444
End of March 1966	53,400	End of March 1965	49,989
End of April 1966	53,100	End of April 1965	49,978
Net increase	500	Net increase	1,129

Time and savings deposits, all banks [1]

[In millions]

1966		1965	
End of December 1965	$145,600	End of December 1964	$126,447
End of January 1966	147,600	End of January 1965	129,200
End of February 1966	148,400	End of February 1965	131,000
End of March 1966	150,900	End of March 1965	132,800
End of April 1966	152,300	End of April 1965	134,100
Net increase	6,700	Net increase	7,653

[1] Includes savings deposits, savings certificates, savings bonds, nonnegotiable CD's, negotiable CD's, and time deposits open account.

The CHAIRMAN. All right. Please clear the room, and we will go into executive session.

(Thereupon, at 11:15 a.m., the committee proceeded into executive session, to reconvene subject to the call of the Chair.)

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TO ELIMINATE UNSOUND COMPETITION FOR SAVINGS AND TIME DEPOSITS

THURSDAY, JUNE 23, 1966

House of Representatives,
Committee on Banking and Currency,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Barrett, Mrs. Sullivan, Reuss, Ashley, Moorhead, Stephens, St Germain, Gonzalez, Minish, Grabowski, Gettys, Todd, Ottinger, McGrath, Hansen, Annunzio, Rees, Widnall, Fino, Mrs. Dwyer, Halpern, Brock, Talcott, Johnson, Stanton, and Mize.

The Chairman. The committee will please come to order.

We have several witnesses this morning and we have first, the representatives of the savings and loans—if you gentlemen will please take your places at the witness table.

This morning we are trying to resolve some questions. Just to bring you up to date on what happened the other day, the Weltner motion to have a 5-percent interest rate on CD's with certain restrictions was adopted in preference to 4½ percent. That was section 1 of the Hanna-Moorhead-Reuss amendment. When we met last, Mr. Todd gave notice that he was going to ask for a reconsideration, having waited for it, and we asked him to withhold the motion without losing any rights until Mr. Reuss could be heard from, who wanted to offer amendments to the bill, which he did. We went ahead and considered the bill and approved only sections 2 and 3 of the Hanna-Moorhead-Reuss amendment.

Section 2 only qualifies the power of the Board of Governors to regulate minimum reserve ratios and maximum interest rates—that is, from 3 to 10 percent. And section 3 makes the powers of the FDIC to regulate interest rates on time and savings deposits in insured nonmember banks consistent with the powers of the Federal Reserve Board with respect to such deposits in member banks. That is section 3.

Then we came to section 4, having discussed it, which authorizes the Federal Home Loan Bank Board to regulate rates of interest or dividends paid by institutions insured by the Federal Savings and Loan Insurance Corporation.

We decided there that we should not go further on that without hearing from the Federal Home Loan Bank Board as its Chairman was not heard on this issue before this committee.

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Also, the representatives of the savings and loan associations have not been heard from on this matter so we felt like it would be unfair to proceed further until we gave you gentlemen an opportunity to be heard. We realize this is a pretty broad thing. We intended to have Mr. Horne as our first witness this morning before having you gentlemen, but Mr. Horne was unavailable as he was out of the city on a matter of great importance to him and he feels the country, too, and he could not get back here until early this afternoon. We agreed to hear you gentlemen first and then hear him this afternoon. But yesterday I asked unanimous consent, having conferred with Mr. Widnall, the ranking minority member first, and it was satisfactory to him, that we be privileged to meet this afternoon notwithstanding the fact that the House will probably be in session, and that was objected to, so we cannot meet this afternoon.

So our situation is, we will hear from you gentlemen and we will have to hear from Mr. Horne at some subsequent date. The housing bill—Mr. Barrett informs me—was reported out by the subcommittee yesterday afternoon and we are to give early attention to that. That is one of the most pressing bills on our "must" list and I had in mind asking the committee to hear Mr. Barrett and his subcommittee on Tuesday and also have Dr. Weaver here for the administration in executive session and see whether or not we want to report the bill out Tuesday, or whether or not we want to have additional hearings or do whatever might be suggested by the members of the committee.

Any comments on that that anyone would like to make? Does that sound all right to you? Then we will have Mr. Horne about Wednesday if we hear from him before the recess.

Mr. TODD. Mr. Chairman, I would like to express my concern that these hearings have gone on for so long now that we will not take action which will be effective to prevent the withdrawals of funds from the savings and loans. I would hate to have the hearings drag out. The crisis has past and we have taken no action which will ameliorate it. I know in my area there is real concern that something be done to prevent a major withdrawal from savings and loans on the first of July.

The CHAIRMAN. I share your concern, my dear sir. I thought this morning when the testimony was finished here, if you gentlemen will make it brief, because I feel like you can under the circumstances, that we will try to resolve this this way: We have only got one question before us, really, and that is, the Federal Reserve on December 6 raised these rates from 4 percent to 5½ percent which has caused all this trouble. They have not denied that. In fact, Mr. Martin said that he realized the savings and loans were placed at a disadvantage. He said that in his testimony. We all know that they are placed at a disadvantage. It has put them in such a position that the homebuilding industry has practically stopped functioning, at least it is down. I think we want to do something to correct that. If we want to do it, we can vote on it. If we do not want to do it we are going to have to stretch these things out much longer. I think that is the question before us and that is the question I want to put before the members of the committee when these people get through this morning, if it is all right with the membership. Does that sound all right?

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Mr. REUSS. I wonder, Mr. Chairman, whether it is necessary that we wait until Wednesday to hear Mr. Horne. After all, we have a letter in the record from Mr. Horne expressing his views on these matters and we have before us a member of the Board here, if anybody wants to ask him any questions. I would not think it is necessary.

The CHAIRMAN. It is possible we can get through here by 11:30 and see if we can resolve something. Will that be satisfactory?

Mr. REUSS. Sounds great.

The CHAIRMAN. Without objection, we will just cut off at 11:30 and see if we cannot come to some agreement. If we can, of course, well and good. If we cannot, we have lots of time before us for hearings.

All right, who is first on the agenda?

Mr. Bliss, all right.

STATEMENT OF GEORGE L. BLISS, PRESIDENT AND MANAGING DIRECTOR, COUNCIL OF MUTUAL SAVINGS INSTITUTIONS

Mr. BLISS. My name is George L. Bliss. I reside in Mount Vernon, N.Y. I am president and managing director of the Council of Mutual Savings Institutions, the headquarters of which are in New York City. If you gentlemen want me to continue——

The CHAIRMAN. You may add to your statement when you look over your transcript and add any material information you desire to have inserted.

Mr. BLISS. The council was organized in 1962 for the purpose—to quote from its constitution—of "advancing the distinctive and traditional activities of all mutual savings institutions." Its membership consists of mutual savings, building or homestead associations located in some 35 of the States, the District of Columbia, and Puerto Rico. This statement was authorized at a meeting of our board of directors on June 8–9.

The members of our council are very much concerned over the rate war that has developed in the past few months with respect to the rates of interest paid on savings and time deposits, the result of which has been to upset the normal balance in the operation of the several types of financial institutions. We appreciate very much the time and the study of this problem which has been made by your honorable committee. We will contribute a proposal that is somewhat different from suggestions heretofore advanced from other sources, but one which we respectfully submit is directed to the root of the problem.

By way of background, we deem it important to recognize that, for many years it was the traditional concept of sound banking operation in this country that commercial banks, as demand deposit institutions, should restrict the investment or lending of their funds to a short-term basis; and that deposits in savings institutions and policy reserves of insurance companies, which constitute long-term funds, in fact, should be the major source of long-term credits.

However, over a period of years the commercial banks have been steadily increasing their volume of long-term credits, which change in policy has been rationalized by aggressively seeking, and in numerous instances accomplishing, legislative amendments empowerng them to accept savings deposits and to extend long-term credits in the

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mortgage loan and other fields. Parenthetically, it may be noted that this development has spurred the savings institutions—the great majority of which are chartered or organized on a mutual or cooperative basis—to act defensively by seeking an expansion of their powers into other fields of investment.

One of our directors of the council epitomized our thinking on that state of facts, when he said that it is futile to believe we can ever chase either group back into the cage from which it has escaped.

Neither do we believe that control of interest rates, that is, the establishment by governmental agencies or officials of so-called ceilings on rates of interest that may be paid by the different types of financial institutions, or on varying types of accounts, would prove a practical solution, the reasons for which will be developed later in this statement.

What we do propose is the utilization of existing machinery, readily available, and which we believe can be adequately and appropriately brought into play; namely, an adjustment in the required reserves of commercial banks, which is the long-established and traditional method of controlling the volume of bank credit.

We submit that a recent development warrants a reappraisal of the use of required reserves; namely, the fact that in recent years an increasing number of the commercial banks have been issuing certificates of deposit with definite maturity dates which, at maturity, have all of the characteristics of demand deposits. The volume of maturing certificates of deposit in the commercial banking system in the latter part of 1965 would be large, and the prospect of "rolling over" the certificates then maturing was so uncertain, that the Board of Governors of the Federal Reserve System hastily acted to increase the maximum rate of interest permitted to be paid by commercial bank on time deposits and certificates of deposit, as the members of this committee well know.

At this point, we feel it important to draw to your attention that, at the same time, there has been an erosion in the effectiveness of credit controls through a dilution of the manner in which required reserves are computed. To cite some instances, a number of years ago, member banks were authorized to include vault cash in measuring compliance and, more recently, the ratio of reserves required against time deposits was reduced to 4 percent. Further, and this is a matter as to which members of this committee are reported to have expressed concern, the definition of "float" has apparently been enlarged to lessen the ratio of required reserves.

Against the foregoing background, which we have attempted to present in summarized form and as briefly as possible, we respectfully submit the following proposal:

> That, by legislation or such other means as your honorable committee finds appropriate, the commercial banks which are subject to the jurisdiction of Federal agencies be required—
>
> 1. To classify time deposits, certificates of deposit, outstanding promissory notes and other bank obligations, by whatever name known, which are issued with a specific maturity, as demand deposits when within 90 days of maturity and, thereupon, subject to the reserve or other requirements applicable to demand deposits.

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2. To establish reserves at one-half of the rate applicable to demand deposits, with respect to time deposits, certificates of deposit, outstanding promissory notes and other bank obligations, as listed in the preceding paragraph, when within 6 months (but more than 90 days) of maturity.

A copy of the formal resolution of the Council's board of directors making this proposal is appended to this statement.

Because the press announcement stated that this committee desired to hear expressions of views on the feasibility of interest rate controls, the following is a brief summary of why we regard that approach as not feasible:

1. It is a basic feature of mutual savings institutions that, after the payment of operating expenses and the provision of reasonable reserves for possible future losses, the earnings remaining shall be distributed as interest-dividends to the member-depositors. Over the years, this has resulted in a higher rate of return by some of these institutions than others; nor has that proved to be a problem of any proportions. (Incidentally, it may be relevant to point out that, by virtue of their mutual plan of organization, neither can these institutions promise a specific rate of return for any future dates.)

2. Because of the great variance in economic conditions in the different parts of the country, a ceiling on the rate of interest permitted to be paid would be inequitable. We recognize that the higher rates paid in some areas are disturbing to the managements of some of the institutions where earning rates are lower. Nevertheless, as long as there exists a disparity in earning rates, any nationwide ceiling would obviously be inequitable to one area or the other. On the other hand, the subject does not lend itself to handling on a regional basis, because of the ease with which people could cross any line that might be drawn, when they found it to their financial advantage.

3. Finally, we submit there has been amply demonstrated the psychological problem inherent in rate ceilings. The very existence of established ceilings results in widespread publicity whenever a change in the ceiling rate is made, with the result that any institution which feels that circumstances warrant a lesser rate is put on the spot to defend its position—so that, as the managements of many institutions have pointed out, the ceiling rate tends to become the prevailing rate, not infrequently with disastrous results.

(The resolution referred to follows:)

COUNCIL OF MUTUAL SAVINGS INSTITUTIONS

Whereas, in recent years an increasing number of the commercial banks of this country have been issuing certificates of deposit with definite maturity dates which, at maturity, have all of the characteristics of demand deposits, and

Whereas, the volume of maturing certificates of deposit outstanding in the commercial banking system in the latter part of 1965 was so large and the prospect of "rolling over" the certificates then maturing was so uncertain, that the Board of Governors of the Federal Reserve System hastily acted to increase the maximum rate of interest permitted to be paid by commercial banks on time deposits and certificates of deposit, and

Whereas, as a consequence of such action, the normal balance in the operation of the several types of financial institutions has been upset, to the extent that its restoration is currently the subject of intensive Congressional study, now, therefore, be it

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Resolved, That the Board of Directors of the Council of Mutual Savings Institutions does hereby respectfully petition the Congress to adopt legislation amending existing laws governing the operation of such commercial banks as are subject to the jurisdiction of Federal agencies, in the following manner:

1. To provide that time deposits, certificates of deposit, outstanding promissory notes and other bank obligations, by whatever name known, which are issued with a specific maturity date, shall be classified as demand deposits when within ninety days of maturity and shall, thereupon, be subject to the reserve or other requirements applicable to demand deposits.
2. To provide that time deposits, certificates of deposit, outstanding promissory notes and other bank obligations, as listed in the preceding paragraph, when within six months (but more than ninety days) of maturity, shall be subject to one-half of the reserve or other requirements applicable to demand deposits.

I certify this to be a true copy of a resolution adopted by unanimous vote at a meeting of the Board of Directors of the Council of Mutual Savings Institutions on June 9, 1966.

GEORGE L. BLISS,
President and Managing Director.

The CHAIRMAN. Thank you, sir. I would like to ask the other witnesses to confine their statements to really what is involved here. The interest rate, and, of course, section 4, of Mr. Reuss' amendment dealing with interest rate control. If we get through in time, of course, we are going to pass on this and it is up to you gentlemen to cooperate with us.

Mr. BLISS. I did not mean to deviate except we offered an alternative.

The CHAIRMAN. That is right. I am not criticizing you. The information you submitted was helpful. We appreciate it.

The next witness is Mr. Sherbourne.

STATEMENT OF EVERETT C. SHERBOURNE, PRESIDENT, CITY FEDERAL SAVINGS & LOAN ASSOCIATION, WHIPPANY, N.J., ON BEHALF OF THE NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS—Resumed

Mr. SHERBOURNE. My name is E. C. Sherbourne, president, City Federal Savings & Loan Association of Whippany, N. J.

Mr. Chairman and members of the committee, it is a distinct pleasure to reappear before you in these important and searching deliberations concerning the turmoil in the savings market and the consequent critical contraction of the housing and residential real estate markets.

I want to point out that the material I had prepared shows that these problems stem from the conditions I described and I was going to summarize it briefly, since they do not stem from a lack of rate control over savings and loan associations.

If you wish, I can confine myself specifically to that area of rate control, in which case my statement will be very short. I want to direct the committee's attention to the fact that the problem facing the committee today stems from the critical shortage in the housing finance market created by the action of the Federal Reserve Board, that our type of institution has been sufficiently regulated over the last 3 years and that we are losing ground with respect to commercial banks. Therefore, for me to comment only on this last proposal of dividend rate control in the savings and loan industry would be to deviate from what I consider the major problem. However, Mr. Chairman, in light

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of your comment, I will simply proceed to read the last two paragraphs on page 3 of my 4-page statement.

It was this committee's predecessor in the 1930's which guided the Congress in enacting the statutory provisions granting the Federal Reserve Board the discretionary authority to control interest rates on commercial banks, and prohibit the payment of interest on demand deposits. I found it difficult to believe that this charge of the committee and the Congress has been carried out recently in good faith. It is difficult for me to differentiate between a flat prohibition against the payment of any interest on demand deposits, and authority to pay 5½ percent on money that matures within 30 days. I would suspect that the average life of the ordinary demand deposit in a commercial bank far exceeds 30 days in duration.

The question raised by the committee today pertains to a statutory rate control over savings and loan associations. This is surely a rhetorical question. Savings and loan associations have had effective rate control for the last 3 years through the Federal Home Loan Bank Board's policies on credit, interest rates, reserve allocations, and other Board actions.

That is all, Mr. Chairman.

(The complete statement of Mr. Sherbourne follows:)

STATEMENT BY E. C. SHERBOURNE, PRESIDENT, CITY FEDERAL SAVINGS AND LOAN ASSOCIATION OF WHIPPANY, N.J., ON BEHALF OF THE NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATIONS

Mr. Chairman and members of the committee, it is a distinct pleasure to reappear before you in these important and searching deliberations concerning the turmoil in the savings market and the consequent critical contraction of the housing and residential real estate markets.

In my previous appearance I outlined the genesis of the current problem. It stems from the repeated upward revisions of the rates which commercial banks have been permitted to pay on time deposits from January 1961, to December 1965, under the aegis of the Federal Reserve Board. During this period the Board has most accommodatingly increased the rates payable on time deposits and simultaneously shortened the qualifying period in which to earn the higher rates from 6 months to 30 days and the negotiable CD volume has risen from zero to about $18 billion. About half of this $18 billion of negotiable CD's are in the major New York banks, while about 30 of the largest banks in the country have over 75 percent of all such deposits.

The rapid and unparalleled growth of the volume of these short-money-market claim instruments has resulted in a series of liquidity crises for the issuing banks, which the Federal Reserve Board has consistently "cured" by raising the interest ceiling. Last December was a prime example of such a liquidity crisis. The volume had grown by that time, and has increased since, to the extent that the Board was at its mercy, and the normal relationship of money manager to institution supervised was completely reversed. The Board had no control over the situation, and had no choice in their judgment, but to increase the rate to 5½ percent and shortened the maturities to 30 days. It had to permit the banks using the CD money instrument to pay whatever it cost to roll over the December maturities. This the Federal Reserve did, although I am quite confident that many of the Board members felt that in increasing the rate to 5½ percent, they were providing the banks with an interest ceiling, which in effect was not a ceiling, but provided more than ample room for them to bid and obtain whatever quantities of these short-term funds as they desired.

The charge that the growth in the volume of commercial bank CD's, and their concentration in a relatively small number of so-called money-market banks, which also hold substantial sums of correspondent deposit balances from banks all over the country, resulted in a situation in which the Federal Reserve Board was no longer master of the situation has not even been attempted to be refuted by any of the Board members or other bank supervisory witnesses appearing before your committee. At the most they have attempted to hide behind the age-

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old facade that the banks had to remain competitive. Such a rejoinder, does not obscure the real question concerning the soundness of the banking system as a result of such practice. It does not answer the real concern that a basically dangerous situation exists, which can and to some extent has permeated to many other banking regions, again under the compulsion of remaining competitive.

As could be expected from a prolonged diet of such practices, the supply of long-term funds for housing and related industries, and the great American homeownership public has been adversely affected and severely restricted.

It was said by the leading and most respected monetary official in this country and the world last fall that there were many "disquieting similarities" between the present state of affairs and 1929. I wonder if within such "disquieting similarities" should not be included the uncontrolled competitive race of purchasing short-term money claims at sharply higher rates in the form of CD's.

It was this committee's predecessor in the 1930's which guided the Congress in enacting the statutory provisions granting the Federal Reserve Board the discretionary authority to control interest rates on commercial banks, and prohibit the payment of interest on demand deposits. I find it difficult to believe that this charge of the committee and the Congress has been carried out recently in good faith. It is difficult for me to differentiate between a flat prohibition against the payment of any interest on demand deposits, and authority to pay 5½ percent on money that matures within 30 days. I would suspect that the average life of the ordinary demand deposit in a commercial bank far exceeds 30 days in duration.

The question raised by the committee today pertains to a statutory rate control over savings and loan associations. This is surely a rhetorical question. Savings and loan associations have had effective rate control for the last 3 years through the Federal Home Loan Bank Board's policies on credit, interest rates, reserve allocations, and other Board actions.

In my hand at this moment I have a copy of voluminous new regulations issued only yesterday by the Board on this very subject. The Chairman of the Federal Reserve Board has already told this committee that he would not recommend specific statutory interest rate ceilings of bank certificates of deposit. He prefers flexible authority to pursue the program as he and other Board members see the bank's position vis-a-vis the money market.

In this respect, I should point out to the committee that the money market conditions that exist today appear to auger for even a higher rate on CD's. Federal funds traded yesterday for 5½ percent—a new alltime high—this is 24-hour money that the banks borrow from each other; recent short-term agency issues have been priced in the market at 5.75 percent. It makes one wonder whether the Board, without the confrontation of these hearings, would not have already further increased the 5½ percent ceiling to 6 percent or above on the same old basis that the banks must remain competitive—without any attention to the formidable underlying banking question of the soundness of such practices.

We believe that the central question before this committee is not whether savings and loan dividend rates should be subject to statutory control, for they already are under effective control; but whether action should be taken to correct serious mistakes in Federal Reserve policy which have led to chaotic conditions in the long-term money market.

Knowing this committee's keen interest in maintaining strong housing markets throughout the Nation, we can only sound a warning note that unless corrective action is taken, serious and possibly irreparable damage to our housing goals will result in the months immediately ahead.

The CHAIRMAN. Mr. Strunk.

STATEMENT OF NORMAN STRUNK, EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS & LOAN LEAGUE

Mr. STRUNK. Mr. Chairman, I would like to submit my statement.

The CHAIRMAN. You may insert it in the record.

(The statement of Mr. Strunk follows:)

STATEMENT OF NORMAN STRUNK, EXECUTIVE VICE PRESIDENT, UNITED STATES SAVINGS & LOAN LEAGUE

I appreciate this opportunity to testify in behalf of the United States Savings & Loan League on the savings situation and certificate of deposit legislation.

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The League's 5,100 member associations represent over 95 percent of the total assets of the business and include State and Federal savings associations, insured and uninsured associations, large and small institutions, and mutual and stock associations.

On May 16, I testified at some length as to savings competition and the growing reduction in the availability of mortgage credit. On June 8 and again last Thursday, June 15, further memorandums were addressed to each member of the Banking Committee. Basically, our position has not changed and I will try to avoid being repetitious.

We do not pretend that there is any simple pat solution which will be universally popular in the financial community. But we are appreciative of the committee taking its valuable time in an attempt to develop some way to ease the rate war in the savings field.

Before I even get started in my specific testimony, I want to make it perfectly clear that whatever problems are facing thrift institutions and the housing market have nothing whatsoever to do with the basic soundness and financial strength of our institutions. We don't want these hearings to be incorrectly construed as an evidence that Congress is being requested to help the savings and loan business. The one and only thing we are talking about is the diversion of savings away from the mortgage market as a result of the major change in regulation Q last December. Our business may be no larger at the end of this year than at the beginning, but it will be a stronger business.

The loans we are putting on our books this year are of extremely high quality and, of course, are being made at higher rates. The small handful of institutions with worrisome delinquencies and some foreclosed real estate are being able to clean up these problem assets in short order. Our service to the savings public will continue in uninterrupted fashion and the savers with our institutions will continue to receive just rewards for their money.

The entire problem, as we have constantly emphasized, is not a problem of the savings and loan business per se but a problem for the homebuilders and homebuyers because there will be many billions of dollars less available for homebuying this year and next year.

We also want to point out that in time the earnings of our institutions will increase. Low-interest-rate loans will be paid off and replaced by higher interest rate loans. We will be able in the next few years to match the higher rates being paid by the banks for savings, but those higher rates, of course, will be at the expense of those who buy homes. This is the inevitable effect of tight money and the escalation of rates paid for savings.

We have emphasized that this is a temporary period. It is essentially a problem of adjustment to higher interest rate levels. Because of the manner in which our funds are invested, it is difficult to adjust our earnings and our dividend rates upward as rapidly as commercial banks which are primarily short-term lenders.

Over the long run, we are confident that the savings and loan business will be able to boost its earnings and once again compete very vigorously for savings with the commercial banking business. We are not concerned over competition for the long pull. We are concerned, however, over funds for mortgage lending for the near future simply because the decisions of the Federal Reserve Board last December gave no consideration to the needs of thrift institutions and the home mortgage market for a transition period to absorb sudden and dramatic changes in the rules of the game in the savings market.

I know that members of this committee, like many savings and loan and commercial bank executives, are deeply disappointed that the Federal Reserve authorities, which let this present situation develop, apparently are unwilling to take even modest steps which are within their legal authority to bring some sense of order and balance into this picture. I, frankly, thought that by now, with the obvious great shortage of mortgage credit not only for homebuilding, but for homebuying and with the obvious concern about it on the part of the Congress, that the members of the Federal Reserve Board would be able to agree on a program and forthrightly take steps to avoid an even more hectic condition in the months ahead.

When I testified before this committee some 5 weeks ago, I suggested some modest, nonlegislative steps that the Federal Reserve could take to correct current imbalances in the savings field. These steps could then have helped the situation and they still can. The suggestions were that the automatic renewal feature of consumer CD's be eliminated, that the practice of banks in issuing

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certificates with dual maturities be eliminated, and that steps be taken to eliminate misleading advertising by the banks of their consumer certificates.

In that connection, I know that the committee files have many examples of bank ads, but I would just like to submit for the committee record an advertisement that appeared in the Chicago Tribune the day before yesterday from the Exchange National Bank of Chicago, advertising in very large print 6-percent savings certificates, et cetera. Either this bank is openly violating the regulation or the advertisement is blatantly misleading.

One additional step needs to be taken now as the situation has deteriorated further and that is to lengthen the allowable maturity on consumer CD's, a point which I will discuss in a few minutes.

As I understand it, we are invited here today to discuss two items—a possible interest rate ceiling on consumer-type certificates of deposit and the subject of dividend controls for savings and loan associations.

As to the bank rates, our June 15 memorandum expressed the belief that it would take a 4½-percent CD ceiling to effectively check the existing imbalance in the flow of savings in commercial banks as compared to thrift institutions. In the first 4 months of the year, commercial banks received 87 percent of the total savings gain. Savings banks and savings and loans divided the other 13 percent. Expressed another way, the savings growth in banks in the first 4 months of 1966 was down about 12 percent from a year ago whereas the savings gain in our associations was off about 70 percent and for savings banks, off about 54 percent. This is a much more abrupt and significant change than we believe any of the banking authorities anticipated, and too much of a change to be absorbed without major disruptions to the real estate economy.

We know that in seeking corrective legislation, the committee also wants to avoid making changes which might "overdo" it in the opposite direction. We think a 4½-percent bank CD rate would give the proper balance. We are doubtful that a 5-percent level would have any appreciable corrective impact on the current situation but obviously it would be useful in forestalling even further bank increases above the 5-percent level. If a 12-month minimum maturity were established for consumer-type certificates of deposit, at whatever rate the committee decides upon, it would be very helpful. Savings and loan associations now are able to offer 6-month certificates, but we are doing this only to match the short maturities of the bank certificates. We are certain that the Federal Home Loan Bank Board would be very happy to prescribe a minimum 1-year certificate if this were the minimum term for bank certificates. Certainly the savings and loan business would be happy to go back to a minimum 12-month certificate maturity.

After all, money that is invested for less than 1 year is hardly true savings and has no real claim to a "bonus" rate. A 12-month minimum maturity would dissuade a good many savers from shifting from a bank passbook account or savings and loan account into the higher yielding certificates.

Before addressing myself specifically to the subject of Federal Home Loan Bank Board control over savings and loan dividend rates, I think we need to remind ourselves where this present problem started and the function of rate controls over the banking business but without such controls over other types of financial institutions—savings and loan associations, mutual savings banks, and credit unions.

Until December of last year, there was reasonable order and balance in the savings market. The past few years savings and loan associations, mutual savings banks, and credit unions had conducted themselves with considerable restraint with respect to rates paid for savings. Commercial banks were enjoying quite a satisfactory flow of savings. The banking business in 1965 attracted (net) $17.8 billions in new savings and time deposits (of which $3.4 billion was corporate CD's) compared to $8.4 billion for savings and loan associations, $3.9 billion for savings banks, and $1.1 billion for credit unions.

Everyone was getting a reasonable flow of new savings and our institutions were able to continue a satisfactory amount of mortgage lending although a volume considerably under that of the last few years.

Today's problem was not created by dividend rate increases on the part of savings and loan associations. It was created by the increase in allowable rates on bank CD's to 5½ percent. Even with this increase in bank rate ceilings, our business still has continued to conduct itself in a responsible manner dividend rate-wise.

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It should be clear in everyone's mind that bank interest control—regulation Q—was not invented or fostered by the savings and loan business. It was established after the depression by Congress for the protection of the public interest and for the protection of banks. It has operated all these years not to help the savings and loan business but because the Congress and the Federal agencies, and the bankers themselves, thought it was in the best interest of banking.

For a variety of reasons, some control by the banking authorities over the prices that banks pay for money has always been considered necessary to the continued strength and vitality of the banking business. At least that was the judgment of Congress in the 1930's based on its review of banking history throughout the 1920's and early 1930's.

Today's problem is not the absence of dividend controls over the savings and loan business or over other so-called financial intermediaries but the absence of realistic controls over rates paid for savings and time deposits by commercial banks. We think the December rules with respect to the offering of consumer CD's, left too much room for unanticipated innovations on the part of the banks in promoting certificates for ordinary savings. In addition, it should be noted that although the law prohibits the payment of interest on demand deposits, this prohibition is circumvented for all practical purposes by the payment of interest on 30-day certificates. A 30-day CD comes mighty close to being a demand deposit. It is worth noting that in all of the arguments by bank spokesmen against statutory or rigid rate ceilings over commercial banks, we have yet to hear a banker complain about the most important statutory ceiling of them all—the absolute prohibition against paying any interest on demand deposits.

With respect to proposed dividend controls over the savings and loan business, if there were something grossly unfair or unwise about the absence of controls over our institutions, savings banks and credit unions while there have been controls over rates paid by the banks—a situation that has existed for over 30 years—certainly the Congress would have heard about it long ago. We cannot believe that this longstanding arrangement has suddenly, overnight, become a situation that must be reversed in the next few weeks.

Our institutions operate under a responsible Federal Home Loan Bank Board that has been willing and able to take satisfactory steps to prevent ruinous rate competition. We operate under regulations that require substantial amounts to be placed in reserves that acted as a major restraint on unwise dividend rate increases. This regulation today gives the Board authority to require an association to reduce its dividend rate if it does not meet the prescribed allocations to loss reserves. Another Board regulation restricts the amount of loan fees and commissions that may be taken into current income and this also serves to curb the dividend-paying ability of associations. Finally, it should be recognized that there are ceilings on home mortgage loan interest rates in many States that are quite low in the light of today's interest rate structure and which effectively restrict the dividend-paying ability of savings associations.

Finally, I point out that the Board has prescribed certain guidelines on dividend policy and has controlled the availability of Federal Home Loan Bank credit as a way of restraining unwise rate competition within the savings and loan field.

This program worked quite satisfactorily until the Federal Reserve Board's action on regulation Q last December complicated the administration of it by Chairman Horne and his staff. In spite of the handicaps, this program is still rather effective.

In connection with the possibility of rate controls over our institutions in relation to those of the commercial banks, it must be remembered that there is no proposal for Congress to put any strings on the ability of the banks to attract the large corporate CD's. It would be a travesty if there were now, for the first time, dividend controls over the savings and loan business when obviously this business did not start this rate war and when in fact there would be no effective price controls over the rates paid by the big banks for large corporate time deposits.

We feel that the subject of Federal Home Loan Bank Board control over savings and loan dividend rates is entirely too basic and fundamental a question to be resolved in brief hearings on what is essentially a temporary, emergency bill. There already has been legislation introduced on this subject through the normal channels, but it has not been reached for regular hearings. When the

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committee wants hearings on this subject, we will certainly be willing to go into the entire discussion in great depth.

As members of this committee have pointed out, if there is a move to equalize the prices paid for savings or regulatory controls over the rates paid, the Congress must in all fairness take major steps toward equalizing operating, investment, and earnings opportunities. There could scarcely be a more complex or fundamental issue than the proposition recently suggested (for long-range study purposes) by Governor Robertson of the Federal Reserve that all financial institutions be equalized in all directions so that savings and loan associations and savings banks have all of the powers of commercial banks and are subject to all of the restrictions of the commercial banks, and vice versa. Of course, the greatest advantage the commercial banks have is their interest-free demand deposits and the attendant ability to actually create money. To extend this authority to all thrift institutions—and we have never even asked for it—would have a phenomenal impact on the entire economy and our whole monetary policy.

In connection with controls over rates paid by savings and loan associations for savings, Congress will, of course, recognize that the savings and loan business is but a part—although a large part—of the total savings market. Certainly, if there are to be controls over rates paid by savings and loan associations, consideration must be given to controls over rates paid by savings banks, credit unions, and life insurance companies on accumulated policy reserves and insured pension funds. In this connection, Congress should be aware of the fact that a large portion of the savings bank business is not under any form of Federal control whatsoever. Many are not members of the FDIC or of the Federal Home Loan Bank System. Only about half of the credit union business is under a Federal charter and subject in any way to Federal regulation of prices paid for savings.

All we have ever suggested is just a modest, temporary adjustment of the terms and rates for relatively short-term, savings-type certificates of deposit; the type of temporary, moderate adjustment which the committee apparently expected the Federal Reserve to undertake under discretionary legislation. Certainly these proposed modest, temporary restrictions on a very small portion of the banking business (there would be no effect at all on demand deposits, passbook savings, or corporate CD's) do not justify sweeping new controls over savings and loan associations. Such control would apply to very dollar we have, not just a small portion as in the case of commercial banks.

We understand that once the issue of dividend controls was raised, the committee had little choice but to receive some testimony on the subject. But we hope that on further reflection, the committee will recognize that it is not a question to be decided at this time and in this manner. I can think of nothing that would cause more new confusion and uncertainty than for the Congress to suddenly give the Federal Home Loan Bank Board a completely unlimited power to set dividend rates for 5,000 different savings and loan associations, particularly with the banking authorities being either unwilling or unable to control effectively the rates paid by banks for time deposits.

I would like to make one more comment on pending legislation. It appears that the Congress will authorize an increase in the lending activity of the Federal National Mortgage Association. This legislation we support. It is appropriate use of Government authority and existing program to relieve some of the stringency in housing credit.

It should be recognized, however, as a practical matter it is difficult for most builders and realtors to do business with Fannie Mae. The large merchant builders and large real estate firms are able to put together loans for sale to Fannie Mae, but the small builder and small realtor are utterly unable to cope with the procedures and details involved. The smaller homebuilder and the typical homebuyer uses conventional financing and the primary source of conventional financing is the savings and loan business. In 1965, only 16 percent of all home mortgages were insured by the Federal Housing Administration or guaranteed by the Veterans' Administration while 84 percent of all homes were financed with a conventional loan. Fannie Mae, of course, does not buy conventional loans.

In summary, let me point out that the committee currently is addressing itself to a short-range problem and a long-range question. The short-range problem deals with the adjustment of savings institutions to the new, high-rate structure and the higher rates being paid by banks for savings which, of course, is having its primary effect upon the availability of funds for homebuying and homebuild-

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ing. This problem could, in part, be corrected by legislation to provide Fannie Mae with more lending authority and in part by doing something about bank promotion of high-rate, short-term consumer CD's.

I submit that the question of supervisory control over savings and loan dividend rates is a much larger question and has nothing to do with the current problem in the mortgage market and is best dealt with by the Congress at another time and in a broader context.

The CHAIRMAN. We will hear from the next witness, Mr. Pat DuBois.

Mr. DuBois, Mr. Olson, your Representative in Congress wanted to introduce you. We had given him the time that you would probably begin your testimony, but unexpectedly you are going on before that time.

Without objection, we will permit Mr. Olson to insert his introduction of Mr. DuBois in the record.

(Mr. Olson's remarks follow:)

REMARKS OF HON. ALEC G. OLSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Gentlemen, I am honored this morning to have the opportunity of presenting to you one of my distinguished constituents, the Honorable Pat DuBois, of Sauk Centre, Minn.

Certainly Pat needs no introduction to any of you. However, today he is appearing before you for the first time as president of the Independent Bankers Association. Pat was elected president of the association at its last annual meeting in Las Vegas May 3.

You have all heard the saying, "If you want a job to be done well, give it to a busy man." Pat is indeed a busy man. He is not only interested in the immediate affairs of his community. In addition he is a member of the Minnesota State Legislature, currently holding the seat to which he was first elected in 1962.

Pat's election as president of the Independent Bankers Association follows his father's long tenure as first president of the association. Mr. Ben DuBois has, of course, appeared many times before this committee of the Congress in his capacity as president of the Independent Bankers Association.

The Independent Bankers Association was founded by Ben DuBois in Sauk Centre, Minn., and continues to maintain its headquarters there. The board of directors recently confirmed its intent to maintain the headquarters of the association in its birthplace by erecting a home office in Sauk Centre.

Pat DuBois is an outstanding banker and legislator, and I know the Independent Bankers Association will continue to grow and prosper under his guidance as president.

Mr. Chairman, committee members, thank you for allowing me to introduce Pat to you.

The CHAIRMAN. You have been in the room, I understand, Mr. DuBois, and you understand what we are trying to do. We are trying to get some agreement this morning on whether or not we can vote on this.

You will summarize your statement and bring out the points that you think should be brought out and insert the remainder in the record, that will be satisfactory with us. You may proceed in your own way.

STATEMENT OF PAT DuBOIS, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, AND REED H. ALBIG, CHAIRMAN, FEDERAL LEGISLATIVE COMMITTEE, IBA

Mr. DUBOIS. Ladies and gentlemen of the committee, with me today is Mr. Reed Albig who will present a formal position which is quite brief. Mr. Reed Albig is chairman of our legislative committee and

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then, when that statement has been read to you, we will submit to you for questions.

Mr. ALBIG. Mr. Chairman, and members of the committee, my name is Reed H. Albig, president of the McKeesport National Bank of McKeesport, Pa. I am a past president of the Independent Bankers Association of America, having served in that capacity in 1961–62.

I am privileged to be accompanied by Pat DuBois, president of the First State Bank of Sauk Centre, Minn., who is the president of our association, having been elected to that position at our annual convention, at Las Vegas, in May. He is himself a Minnesota legislator, and had just returned to his bank, from a much-publicized State convention, when your invitation was received.

President DuBois has asked me to read our statement, in response to your invitation to appear, and both of us will be glad to respond to the questions of your committee members.

Our association presently has a membership of more than 6,400 independent banks, which is for us an alltime high membership figure. In line with the national figures, about two-thirds of our member banks are State banks and about one-third are national banks.

As one of our fundamental convictions we support the dual banking system, established more than 100 years ago, and now accepted as historic and traditional.

This means we support the integrity of State supervision of State banks and Federal supervision of national banks.

We appear today to comment on H.R. 14026 as the base and starting point for this hearing, on H.J. Res. 1148, and related bills, designed to describe and limit the authority of commercial banks to issue certificates of deposit, and to define the interest rates thereon.

The Federal legislative committee of our association, composed of nine distinguished country bankers serving with the chairman, and with President DuBois and other general officers in attendance, met here for 2 days last week and gave extended and intensive attention to these related bills. Last Thursday morning, June 16, we interrupted our sessions to attend your committee's public hearing, and listen to the second statement given the committee by Chairman Martin of the Federal Reserve Board, and his interrogation by members of your committee.

We are familiar with the draft of the various bills under consideration and respectfully submitted our views by telegram Thursday afternoon, addressing the chairman and all 33 members of your committee.

We reaffirm those views today, as expressing the sense of the Independent Bankers Association, Mr. Chairman, I will read the heart and core of that expression:

We recognize that the thrust of this bill—these related bills—arises from concern for restraining a potential rate war between the mutual thrift associations and the commercial banks.

This possible rate competition contains the elements of damage to both, and is clearly not in the public interest. Likewise, we recognize the potential for interest rate competition within the banking industry, as well as with the thrift institutions.

However, we are opposed to the imposition of restraints on the commercial banks without comparable and appropriate restraints on the thrift institutions, which action we believe is equitable and fair.

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We are mindful of the experiences of the banking industry with former increases in the maximum permissible rates, where the permissible rate has rapidly become the floor as well as the ceiling. In view of this we do not believe a five percent rate will accomplish relief in the rate competition between the thrift institutions and the commercial banks. For such purposes it is our belief that the ceiling should not exceed four and one-half percent.

The applicable rate not exceeding 4½ percent obviously referred to certificates and time deposits which are in the nature of thrift and personal savings accounts, and not to those certificates which are money market instruments.

Mr. Chairman, we are aware that for 30 years, and more, the thrift institutions have been remarkably free of controls. At the same time the payment of interest on savings and time deposits in commercial banks has been under the control of the Federal Reserve Board. We are aware of no convincing reason why steps should not be taken to bring the mutual thrift institutions under appropriate controls.

Further, witnesses before your committee, in hearings on these bills, have discussed the "subsidized sanctuary" in tax matters accorded thrift institutions through the years. We believe all of these problems must be faced and resolved as a part of any real solution by the Congress of these concerns affecting the public interest.

In his appearance before your committee on June 16, Chairman Martin quite candidly expressed to the committee, in response to questions, that he does not believe there is convincing evidence that the mutual thrift institutions are being hurt because of competition with the commercial banks.

Chairman Martin stated that he believes there are, in fact, many and varied reasons for a shift of funds from all types of savings into other forms considered more favorable by investors, and he questioned the timeliness of a change in the permissible interest rate.

We reaffirm other principal suggestions first stated in our telegram:

Authorization to increase reserve requirements should be premised upon authorizing appropriate reserve requirements for thrift institutions and other financial intermediaries. Further, we believe that a system of graduated reserve requirements by size of bank would be desirable.

We are opposed to proposals to require interagency coordination on changes in interest rate limitations.

I would emphasize the word "require." I think it is evident from the statement that Chairman Martin made that there is every disposition to consult others, to work as indicated and that it is appropriate to do so.

We believe the Federal Reserve Board should be given the power to distinguish between certificates of deposit as money instruments and time deposits and passbook savings accounts, which are in the nature of thrift accounts.

Finally, Mr. Chairman, we stated and reaffirm that—

we are opposed to revision of Section 15(b) of the Federal Reserve end of the FNMA, issued as a secondary market operation, as eligible for purchase by the Federal Reserve Board. We believe the purpose of injecting funds into the mortgage market is best accomplished directly through the Treasury Department.

We are aware within the last day or so legislation for that purpose has been introduced, Mr. Chairman.

The CHAIRMAN. Is that your statement, Mr. DuBois?

Mr. DUBOIS. Yes.

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The CHAIRMAN. We have a letter from the American Bankers Association that I feel should be read, and Mr. Clerk, please read the letter from the American Bankers Association.

Mr. NELSON. I am reading the letter as follows:

THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., June 22, 1966.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: It is reported that the Banking and Currency Committee will take final action shortly on various proposals to restrict competition for savings among financial institutions. Accordingly, we should like to reemphasize a number of facts which we believe to be crucial if the committee is to arrive at an effective and equitable solution.

Stripped of all unessential issues, many of the proposals before your committee represent nothing more than an attempt to hobble commercial banks for the benefit of the savings and loan industry. The ostensible reason is the present shortage of housing funds, but the evidence is clear that these proposals will be ineffective in this regard.

We would direct attention to the following points: The slower growth rate of savings and loan associations during recent months is not due primarily to competition from commercial banks. When an attempt was made recently by the Nation's largest mutual savings bank to determine where the funds withdrawn from it were going, it was found—and so reported in the press—that they were not going to a significant extent into commercial bank time deposits. Indeed, the figures showed that over 90 percent of the number of withdrawals and over 80 percent of the funds withdrawn went, in the first instance, to recipients other than commercial banks. This survey simply points up the fact that in a period when money is tight and interest rates have risen to the highest levels since the 1920's, any institution seeking funds in today's market is faced with competition from a wide variety of competitive sources. Indeed, so far as commercial banks are concerned, data for weekly reporting Federal Reserve member banks indicate that the gains made by these banks during the first 5 months of this year in the time deposits of individuals and business have been almost completely counterbalanced by offsetting declines in demand deposits and regular savings accounts.

Any action which results in a forcible diversion of funds from commercial banks by preventing them from attracting their share of the public's savings will affect severely all of those borrowers who rely on commercial banks for credit. Commercial banks are general-purpose lenders, and to the extent they are able to attract deposits, funds are made available to consumers, to farmers, to small businessmen, to industry, to the housing market, to local communities to finance such projects as schools and hospitals, and to the many other types of borrowers. All will feel the pinch if, under misguided efforts to accelerate the growth of the savings and loan industry, commercial banks across the Nation are placed under serious competitive disadvantages.

The imposition of statutory interest ceilings for commercial banks can have disastrous consequences should any change occur in the present financial climate. In a period of rapidly changing economic conditions, the establishment of an appropriate and effective interest ceiling is a matter which requires the exercise of careful judgment plus the ability to act swiftly with changing circumstances. The establishment of ceilings by statute means, in effect, the introduction of rigid controls—difficult to alter or abandon—into an area which is extremely sensitive, and one whose proper regulation is crucial not only to the institutions concerned but also to the entire economy. Certainly a ceiling as low as 4½ percent would cause immediate difficulties in certain areas, most notably in the Far West.

Regulation of savings competition cannot be just or effective if it is to apply to only one of a number of competitors. If in fact the motivation underlying many of the proposals before your committee is to prevent excessive competition, then restrictions should apply across the board, to all competing institutions. To select only one type of institution for restriction—the commercial bank—would make it quite obvious that these proposals are, in effect, special legislation to aid an already favored industry.

Legislation may be needed to prevent competitive excesses or to aid the housing market. The American Bankers Association stands willing to support reasonable constructive measures to achieve these goals, such as increasing the amount

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of funds available to the Federal National Mortgage Association, or increased discretionary authority for the Federal banking agencies.

Sincerely,

ARCHIE K. DAVIS, *President.*

cc: Members of the House Banking and Currency Committee.

The CHAIRMAN. In fairness to the American Bankers Association, we felt that the letter should be presented although we did not receive it until after this committee met this morning. We did not have an opportunity to arrange for some member of this association to be present. But I was glad to have the clerk read it.

Also, I think we should permit the representatives of the two savings and loan associations, since the letter said so much about them, to comment if they desire.

Mr. Sherbourne and Mr. Strunk, you may comment.

Mr. Sherbourne, would you like to comment or would you like to prepare your statement for the record?

Mr. SHERBOURNE. To comment with respect to the letter from the American Bankers Association?

The CHAIRMAN. Yes. I realize you just heard it and you have not had the benefit of reading it.

Mr. SHERBOURNE. Mr. Chairman, the American Bankers Association and the banking witnesses before this committee, however, did not seem to pay adequate attention to the fact that the problem we are discussing was created by the increase in negotiable CD's. They have not said, for example, what we are told, that $18 billion of negotiable CD's are in the major New York banks, while 30 of the largest banks in the country have over 75 percent of all such deposits.

I have heard no adequate answer to the fact that the distortion in money rates caused by the rapid increase from 4 percent to 5½ percent in the CD's has caused a pull on all rates and it is today forcing the U.S. Government and every corporation that borrows, including us—the Federal Home Loan Bank System—to pay a much higher rate. For what reason? What is accomplished? The banking representatives have not paid sufficient attention to the fact that the Federal Reserve Board record itself indicates that until November 1964, the highest rate permitted on deposits under 90 days was 1 percent and that in the year and a half that has elapsed since that time that rate has gone from 1 percent to 5½ percent. In the whole history of monetary control in this system, and I am only a simple country savings and loan manager, I have known of no record similar to that. Yet the banking witnesses have not addressed themselves to that point at all, so therefore, the major corrective action that needs to be taken will not be taken. Unfortunately, the dividend rate control proposal now introduces a whole host of competitive factors which is going to make it very difficult for your committee to move, and I am sympathetic with your position.

But let me point out this, going back over the term of the postwar period.

I recall the day when the U.S. Treasury invested in savings and loan associations to enable them to do the very job which brought them to $110 billion in assets. I remember when the Congress gave tax exemption to permit these institutions to do the job properly. That no longer exists. There is no money coming from the Treasury any-

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more. I recall the fact that the savings and loan business was able to finance the extension of housing that developed in the postwar period with a rate differential over commercial banks of 1 to 1½ percent on savings. That rate differential no longer exists. What we say to the committee is this: Do not let all these charges and countercharges confuse and evade and cloud up this issue that it is the savings and loan business that holds almost 50 percent of the home mortgages in the country. They are the specialists in the home mortgage field. It is the only type of investment that we can make. This tight money market indicates that great problems can develop because banking supervisory authorities have accepted the premise of the ABA, that all we need is an all-service bank and we no longer need special home financing institutions. We are not asking you to protect us. We did not initiate this bill to begin with. We simply point out the problem that exists and one more thing. Government economists are pointing out that 2 million housing units will be needed in the Nation by 1970 and how can those 2 million housing units be taken care of if the savings and loan business is going to be cramped in the fashion that it has been cramped?

Gentlemen, this situation does not exist only in this Nation. I was sent by the State Department to a mission in Libya where there is no home financing system. I found there that basically the commercial banker is interested in the financing needs of industry and commerce and tends to put housing in a secondary position. The commercial banker said, when the Congress passed the tax bill, do not worry about the impact on the housing market, we will take care of it. But they aren't taking care of it today and I am not sympathetic to the problem because in a tight money market the opportunities for earnings are so great in the area of industrial and commercial loans. The demand from the industrial and commercial customers who are the big demand deposit holders of these banks are so great that the needs of the little homeowner become relatively unimportant to such banks.

I have found the same situation in Lima, Peru. I asked them about this.

I ask this committee not to make the mistake that was made in other countries.

Mr. Strunk. Mr. Chairman, Mr. Slipher would like to make a few comments.

STATEMENT OF STEPHEN SLIPHER, STAFF VICE PRESIDENT AND LEGISLATIVE DIRECTOR, UNITED STATES SAVINGS & LOAN LEAGUE

Mr. Slipher. I am Stephen Slipher with the United States Savings & Loan League.

I would like to comment a little on the ABA letter and Mr. Strunk wants to discuss some of the relative parts.

The ABA suggests that somehow or other the money is going from all the thrift institutions into the stock market, or something. The facts are, that of the total savings, the commercial banks have gotten 87 percent of it this year. They have gained over $6 billion where we have gained a half billion. So if the stock market were pulling the money out, why is it not pulling it out of the banks?

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They somehow suggest there has been something evil and unfair about having controls on banks while we have not been controlled.

Here is a book written by the American Bankers Association. When it comes to the subject of controls, it says:

> Payment of interest on time deposits. Bankers have diverse opinions with reference to the regulation of the maximum rate permitted to be paid on time savings deposits. Therefore, we make no recommendations for change in the present system.

So that this is a very late attitude of theirs.

As for the suggestion that everybody be equally controlled, the banks have all these different services and Mr. Strunk is going to mention some of them.

If you go into the bank where you have your checking accounts and do all your other banking business and get exactly the same savings deal, why is anybody ever going to walk down the street to a savings and loan to open up a special savings account?

Mr. Strunk. We are dealing here with a question—the role of specialized institutions and their competition. I think we have to remember that commercial banks have substantial advantages in doing business with the public for savings deposits.

Commercial banks of course have a monopoly on offering checking account services, the commercial banks have a monopoly on literally creating the Nation's money based on the fractional reserve privilege. They have a monopoly on interest-free use of public funds representing tax collections, averaging $5 billion or more per year. Commercial banks may offer trust services while thrifty institutions may not. Commercial banks today offer many nonbanking services while thrift institutions may not. They may make loans, of course, to everybody, a wide variety of loans. They may make consumer loans, furniture loans, automobile loans and yet our institutions are limited very tightly and narrowly to the first-mortgage business, primarily on small residential properties.

Of course, the banks pay interest on only half of their deposits. They have a substantial amount of free money and you just cannot equate savings rates and savings competition and controls.

We have had regulation Q, we have had bank supervisory control over the rates paid by banks for savings for 30 years. That regulation Q was put in under the Banking Act of 1935, based upon the history of the banking collapse in the twenties and thirties. Congress determined that the banks should not have unrestrained competition. Congress determined that banks should not pay interest on demand deposits, because Congress was concerned about the effect of this kind of unrestrained competition for savings and for deposits that the banks pursued in the 1920's.

We think that just now, when we did not start this rate war, to suggest now that there be dividend rate controls over the savings and loan business, to change the situation that has existed and continued for 30 years without major complaint just should not be done on the basis of piecemeal emergency legislation. It is too big a subject. We did not start the problem and we do not think that the Congress should now impose dividend rate controls through the Federal Home Loan Bank Board, particularly when these controls over the banking business would be administered by the Federal Re-

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serve which is apparently unwilling or unable to control the rates paid.

The CHAIRMAN. Mr. Bliss, would you like to comment briefly on this?

Mr. BLISS. No, Mr. Chairman, I think they have amply covered it and I support their statements.

The CHAIRMAN. If you want to file additional statements, you may do so.

We face this situation, members of the committee: Shall we interrogate the witnesses until 11:30, or shall we take this time for executive session? Does anyone feel that we should interrogate the witnesses?

Mr. REUSS. I would like a couple of minutes. Maybe we could have a show of hands to see how many people want to interrogate.

The CHAIRMAN. How much time do you want?

Mr. REUSS. Three minutes.

Mr. Strunk, representing the savings and loan industry, we here on the committee are sincerely trying to do something about the homebuilding industry and the savings and loans and one of the things that we had in mind was to set up machinery whereby there would be consultation and coordination between the various regulatory agencies. In order to make it meaningful, some of us think the Home Loan Bank Board ought to be given the power which is requested to set the same kind of ceiling on time deposits that the Federal Reserve has with respect to the banks.

Now, you come here this morning and you say you would like a 4½-percent ceiling on what banks can pay on CD's, yet you oppose empowering the Federal Home Loan Bank Board to exercise similar authority over savings and loans. This would result in situations where banks were restricted to 4½ percent, while savings and loans as I understand can pay 5, or a bonus of 5½ percent, so you would have a reverse process and we would have a repetition of the history of the last 6 months in which the banks, to our distress, have been able to accumulate a disproportionate share of the savings.

The question is, Is that really the final attitude of the savings and loan industry whom we are trying to help? The best you can do is to come in here and say, we want to steal it all back?

Mr. STRUNK. Congressman Reuss——

Mr. REUSS. I say this, because I think you would get a lot further if you approached this problem from the standpoint of the Banking and Currency Committee which is trying to do justice to savings and loans, banks, homebuilders, and homeowners and the people generally.

Mr. STRUNK. We appreciate the fact that it is a very difficult position for Congress to be in, to kind of referee and set the rules and terms of competition between the three types of savings institutions. We are mindful that you want to avoid any changes that might overdo in the opposite direction. Initially, in our appearance before this committee we did not suggest any new rate ceilings on bank CD rates. We came here initially and suggested that there be some administrative changes on the part of the Fed with respect to the dual maturities and automatic renewal features of certificates. We think that in terms of savings and loan dividend rates up until now, that 4½-percent CD rates would have given the proper balance. We said most savings and loan associations do not pay 5 and hence a 5-percent bank ceiling

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would not have any appreciable impact on the current situation. A 5-percent ceiling, of course, would be useful in forestalling further bank rate increases and it would permit the Federal Home Loan Bank Board to vigorously enforce the general rates control program it has had in effect for about a year.

If the Banking Committee feels that it is impossible to set the right rate, and I can see that it could, then establishing some minimum maturities would be helpful—a 12- or even 6-month minimum maturity on bank CD's would be helpful. It is true that savings and loan associations are now able to offer a 6-month certificate, but that is only as a result of action yesterday by the Federal Home Loan Bank Board and I am sure that our people would be happy to go back to the 12-month certificate if this would be the way to equalize the thing without setting legislative ceilings on rates.

We make the point that the Federal Home Loan Bank Board has been operating under some guidelines with respect to dividend rates and our business has conducted itself quite well with respect to them.

Mr. REUSS. If that is so, then what have they got to fear from giving the Home Loan Bank Board the power which it seeks, having particularly in mind the fact that in the case of savings and loans, the real limitation, the ultimate limitation to what you can pay is the fact that the homebuilding industry which you feed is going to dry up if the interest rate gets too high.

Mr. STRUNK. That is right. Homebuilding will dry up if rates go too high.

Mr. REUSS. Why are you fighting this, I think, largely fictitious dragon, which fight, I am afraid, is going to keep the Banking and Currency Committee from addressing itself to the reforms that you ask?

Mr. STRUNK. The Board's guideline program has been somewhat like the President's guideline program in a number of areas. It is flexible and it is based on the carrot approach rather than the stick approach and it does give institutions some alternatives.

Frankly, we are concerned in the Federal Home Loan Bank Board—that they will administer the program much more severely than we think the Federal Reserve would administer a rate control program on the commercial banks at this point. I think the Federal Reserve Board is willing to let the banks pay almost any rate and we do not want to end up being in the controlled business while banks are uncontrolled. Putting rate control on our institutions is like the fellow gets his automobile stolen and then goes and finds himself booked for leaving the key in the car, parking in the wrong place, and not having a driver's license. We might end up in this situation with no effective controls over the banking business, but with new controls over our institutions. We did not start this thing. There are real limits on the rates we can pay that do not apply to commercial banks in terms of commercial bank earnings in this period of high interest rates.

Mr. REUSS. Well, I have heard your answer.

The CHAIRMAN. Mr. Reuss, let me see if I can clarify this thing. If we have any grievance today we ought to get the issue down to one thing. December 6, the Federal Reserve, out of the blue sky just issued these regulations that the interest rates would be increased from

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4 to 5½ percent which was really a rate of 37½-percent increase. That caused all this chaos in the country with other financial institutions.

Now, Governor Robertson of the Federal Reserve Board made a statement which has been quoted here, which I think is worthy of consideration, that all financial institutions should be equalized in all directions. Well, that sounds good. But that will take weeks and months of hearings on that to make a step in that direction. We all realize that. Now, all the problems that are existing today concerning inequality between financial institutions existed December 6, 1965. Now, unless we are willing to just try to adjust that one thing that was done December 6, I doubt that we have a reasonable chance of getting any kind of legislation soon. But if we are willing to say that we are going to roll that rate back to 4½ or 4¾ or 5 percent or whatever the committee wants and we can have a grandfather clause in there, that all who have CD's above that can continue to roll them over indefinitely, so that there would not be any squeeze on liquidity. It would relieve that situation entirely, but suppose you say it does roll back? Who objects to rolling back high interest rates? Who objects to that? Nobody objects to rolling back high interest rates. So if we can just keep our minds on that basic problem of either doing something about December 6 or not doing anything, I think we have got a chance. If we get off on all these other things, we do not have a chance.

Mr. Fino wanted to ask a question.

Mr. FINO. Just one question of Mr. Strunk.

In reviewing your testimony here this morning and in view of the colloquy between you and Mr. Reuss, and to clarify in my own mind your position, let me ask you this question.

If this committee were inclined to favorably report on a bill which would authorize the Federal Home Loan Bank Board to regulate and control rates of interest for dividends, would your organization be opposed to such a bill?

Mr. STRUNK. Yes, sir; we would be opposed to such a bill.

Mr. FINO. Thank you.

The CHAIRMAN. Mr. Moorhead.

Mr. MOORHEAD. I have a few questions to the distinguished gentleman from Pennsylvania, Mr. Albig.

Mr. Albig, is there any justification for this committee to grant the power to create interest ceilings for mutual savings banks and not create the power for putting interest ceilings on savings funds? In other words, is there any basis for making a distinction between mutual savings banks on the one hand and savings and loans on the other?

Mr. ALBIG. I see none, Mr. Moorhead.

Mr. MOORHEAD. Mr. Albig, one other question. I notice that your testimony is that the ceilings should be comparable between thrift institutions and commercial banks and then you seem to suggest a rate of 4½ percent, if I understand you correctly. Are you suggesting, sir, that this committee and the Congress make a statutory 4½-percent ceiling, or is it your testimony that we should urge the Federal Reserve which would have the power to act relatively quickly to put the 4½-percent ceiling on? I want to express my concern about the rigidity of a statutory interest rate and I wonder if you share that concern?

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Mr. ALBIG. A very proper concern, Mr. Moorhead, I am certain. It is a very complicated problem and I would be remiss if I did not express my sympathy with the problems of your committee, Mr. Chairman, in coping with this.

First of all, I want to say that I am sure the commercial banking industry in this country is functioning today pretty much in accordance with the way it is expected to function. It is the one financial instrument we have in this country which makes it possible to direct funds into the segments of the commercial community which require funds at the moment. And I am certainly not unmindful that we are involved in war at the present time, with all of the burden this is putting upon the entire Nation to accomplish our objectives.

There is too little known about the subject that we are involved with here this morning. Statistical information, to the extent that it is helpful, has not been generated and adequately developed. I think there is a disposition to believe that this can be reduced to a simple solution, which is to impose a ceiling on interest rates, and this will resolve the problem. I am certainly sure this will not resolve the problem.

We need to bear in mind that we should use what little information we have. Reference has been made here this morning, and as I flew here on the airplane I read an article in the morning paper, under the byline of Sylvia Porter, with whom I am sure the members of the committee are familiar, in which she was restating the analysis of withdrawals which was recently made by one of the large mutual savings banks. It reports, among other things, that less than 20 percent of money withdrawn from the Bowery Savings Bank during the survey period was reinvested in commercial bank certificates of deposit. With your permission, I will insert a copy of the article.

(The article referred to follows:)

[From the Washington, D.C., Evening Star, June 23, 1966]

SWAPPING SAVINGS FOR STOCK MARKET

(By Sylvia Porter)

Q. Where have the massive amounts of money individuals withdrew from savings institutions this spring gone?

A. First, into the stock market. Second, into higher interest paying certificates offered by commercial banks. Third and only third, into "normal" channels ranging from financing a father's boat to paying for a son's Bar Mitzvah.

These are the key disclosures of a study made by the Bowery Savings Bank of New York, largest mutual savings banks in the country, of the reasons why individuals withdrew a record $23 million from their accounts in the 5 banking day period of March 29–April 4. The survey covered withdrawals of $500 or more, representing outright closings of accounts, reductions in deposits and "passbook loans" (loans made against the security of a passbook).

The Bowery's pattern of withdrawals was duplicated at savings banks and savings and loan associations the Nation over this spring; in April alone, these institutions lost an enormous $1.1 billion in deposits, signaling a convulsion in the money markets.

The drain of funds has been so severe that savings institutions have been compelled to cut back sharply on mortgage loans and there is no doubt that some savings and loan associations are in a major money pinch. The Bowery's analysis, first to be made, is thus of extraordinary importance.

The startling point is that the stock market topped the high-yielding savings certificates of commercial banks as the lure.

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The purchase of stocks and of shares in mutual funds accounted for 23.9 percent of all withdrawals and 21.8 percent of the total dollars involved. A whopping 41.4 percent of all the passbook loans was made for the purchase of stocks.

In contrast, 9.6 percent of the individuals taking out their funds bought a commercial bank certificate of deposit. This accounted for 19.1 percent of the dollars involved. Another 4.7 percent put the funds into interest-bearing bonds, accounting for another 9.2 percent of the dollars withdrawn.

All the other "normal" reasons for withdrawing funds from savings institutions came after these two: Payment of taxes, medical bills, buying or improving a house, financing a car, vacation, etc.

The bank obviously has drawn a profile of a most unusual money phenomenon. What does it mean?

(1) It's persuasive proof that the public was jumping into the stock market on a towering scale earlier this year. The passbook loans represented borrowing against savings to buy securities. The closings of accounts and big withdrawals represented a direct transfer of cash from riskless savings to risky investments. The fluctuation of the stock averages since the dates of these withdrawals indicates that many of the stock buyers now have losses on paper if not in fact and this has moderated enthusiasm. But the public's mounting fascination with stocks is indisputable.

(2) It's clear evidence that the little as well as the big saver is aware of interest rate levels and is willing to follow the high rate payer with his funds. He has not nearly as much loyalty to any type of institution or form of savings as many have believed.

(3) This second point, in turn, suggests that a congressional ceiling of 5 percent on the interest rate which commercial banks may pay on certificates of deposit issued to individuals would help cool the institutional war for savings.

The fundamental message is that the U.S. public has become increasingly sophisticated about interest rates and increasingly drawn to speculating in stocks. Whether our financial institutions and regulations are adequate to cope with today's middle-income American is a real question.

The CHAIRMAN. Have you finished, Mr. Moorhead?

Mr. MOORHEAD. Yes.

The CHAIRMAN. All right. Thank you, sir. Mr. Brock?

Mr. BROCK. If I might summarize the position briefly, may I conclude, Mr. Albig and Mr. Bliss, that your positions are similar in opposing a legislative ceiling on interest rates because of difficulties, is that correct?

Mr. BLISS. Yes.

Mr. DUBOIS. Mr. Brock, in answer to your question, it is the position of our association that we feel something needs to be done and if we cannot get the proper action from the Federal Reserve, who properly have the authority, we believe we must come to the Congress for this. We feel we must stop this rate war and we must stop it soon, or it is going to be damaging, not only to the savings and loan industry, but to many, many small banks throughout this country who are involved.

Mr. BROCK. I think you will find there is no member of the committee that is not sympathetic with the problems faced by your industry, sir.

I would simply ask again, do you think it is good public policy for the Congress of the United States to impose a statutory ceiling on interest rates without any fixed time for its removal, or do you think it better public policy for us to strengthen the regulatory agencies so that they can react to a given economic situation at a specific time?

Mr. DUBOIS. If you can strengthen the regulatory authority, then, of course, this is the better procedure. It is not our proposal that it be for an unlimited time. We are dealing with a 1-year emergency proposition and this would be our position.

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Mr. BROCK. It is necessary today, sir?

Mr. DUBOIS. I think so. Four and a half percent; yes, sir.

Mr. BROCK. Then I misunderstood your testimony.

Mr. WIDNALL. Mr. Sherbourne, did you want to comment on that?

Mr. SHERBOURNE. Yes; thank you for the opportunity. My understanding has been that the rate control over CD's and other time deposits and savings deposits exercised by the Federal Reserve Board is primarily from the point of view of its being controller of the total volume of money credit available in order to prevent inflationary pressures on prices. It is not primarily from the fact that they want to control rate wars between commercial banks or with other types of financial institutions. In my testimony I did not suggest anything about reducing the rate on CD's. That emanated from the suggestion originally by, I believe, the Secretary of the Treasury and taken up by other banking witnesses.

All I said is this: Recognizing the complexity of the problem, if you want to insulate undue impact of these high-rate CD's on savings and loan associations, prevent commercial banks from issuing negotiable CD's or other CD's under $25,000.

My understanding is that the total amount involved is not great, although, let me add as an aside, that I was appalled at the lack of data submitted to you by the banking witnesses with respect to the magnitude of the problem of these CD's because there remained the residual problem as to whether or not you may not be involved by having to set bank standards in that area. My original suggestion was that if you wish to accomplish that insulation of savings and loan associations from undue impact, put the commercial bank on the same basis as us, so far as deposits under $25,000 are concerned, because they are in the area of the small family man. Put them on the same basis with us. Let them compete with us in that area of savings—on a savings account basis. That avoids the liquidity problems in the big bank that has $2 million or $3 million in certificates of deposit where they have to continue to pay 5½ percent. It may be even higher. Let them continue to do that. If the Federal Reserve Board feels that the liquidity problem requires that that be permitted, let them continue. But you see, by restricting CD's under $25,000, you insulate us from too much impact.

The CHAIRMAN. Yes, sir. We have three others who want to ask some questions.

Mr. Widnall.

Mr. WIDNALL. If the committee voted to place a 5-percent limit on the CD's and a minimum 6-month maturity and the authority for the Federal Home Loan Bank Board to control savings and loans dividends, would you support this legislation?

Mr. STRUNK. I do not think so.

Mr. WIDNALL. That is all.

The CHAIRMAN. Mr. Stanton.

Mr. STANTON. Mr. Strunk, this legislation is primarily due to the rapid withdrawal from the savings and loan industry last April? Has this rapid decline continued during the month of May and early part of June? Do you have any figures?

Mr. STRUNK. We had a savings gain in the month of May of approximately $450 million plus. This was a 40-percent decrease from

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the gain in May the previous year. The previous year it was $750 million. So we had a gain in savings of about half of what we had. The month of June has been a pretty good month at the savings window. In June, of course, we have dividend credits which also improve the balances. We think that in the first 6 months of this year our institutions will have an overall net gain of roughly $2.5 to $3 billion, so our institutions are not shrinking. We expect shrinkage in July and of course much of this—much of the thrust of this committee's interest has been with respect to savings flows in the month of July and we expect to go down in savings in July, much of which we probably will make up by the end of the year. As a matter of fact, I think the committee should be aware of the fact that savings and loan business will probably be about as large at the end of this year as it was at the beginning of this year. The difference, of course, is not to the savings and loan associations. A "no growth" year is far from being a catastrophic year. But the whole problem, of course, is the fact that the volume of loans that we make is substantially reduced. We think that in the second 6 months of this year that our loan volume will be about $5 billion. That this will be about $5 billion less than the loan volume in the second 6-month period of last year. The whole problem has been the effect on our customers, not the effect on the savings and loan business.

Mr. STANTON. You are familiar with the different legislation that we are considering—any legislation that this committee passes, especially in light of the 5 percent that we are considering at the present time, will not have any material effect on your business, the savings and loan business, in the month of July, would it not?

Mr. STRUNK. An honest answer must compel the fact that I do not see what can be done now with respect to the month of July.

Mr. STANTON. Thank you very much.

Mr. BLISS. Mr. Chairman, I would like to make sure my answer to Mr. Brock's question is clear.

He asked if we felt that statutory action on dividend rate controls—was that not the question—is desirable?

Mr. BROCK. Yes.

Mr. BLISS. Our answer is, we definitely oppose statutory action on dividend rate controls. We believe that this problem can be better solved and can be effectively solved by adjustment of the required reserves in commercial banks.

Mr. BROCK. Thank you very much.

The CHAIRMAN. In other words, what you are saying, you gentlemen do not object to having a hearing involving all these questions, equalizing all financial institutions. You are perfectly willing for that to go on. Then, of course, you consider all these questions as to savings and loans and banks and mutuals, and then you go into all the questions. What you are objecting to is on an emergency situation, that you go into all these questions now to solve this particular emergency situation. Is that correct?

Mr. BLISS. Yes, sir.

Mr. SHERBOURNE. I wanted to supplement Mr. Strunk's last answer. I have the feeling that if it were not for the hearings of this committee, and I am so advised by a consultant, that if it were not for these hearings, the Federal Reserve Board would now be taking action to permit

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6-percent rates on all CD's because the banks are beginning to hit the ceiling continuously.

The CHAIRMAN. I wish you would repeat that. What have you heard about 6-percent rates?

Mr. SHERBOURNE. Back in December, Congressman, as you pointed out, the Federal Reserve set a ceiling of 5½ percent on time deposits and they thought that would give plenty of leeway. In the space of 5 months that leeway has all been used up and at that point the market conditions are such that the Federal Reserve in my opinion might well be considering a 6-percent ceiling if it were not for the hearings before this committee. Now, further, I have noticed important commercial bankers in our area have indicated recently that they intend to retreat from the high 5½-percent CD's. I feel that action by this committee, even if it could not become effective by July 1, that even the threat of action by the committee will have a salutary effect on the kind of rate competition that we are talking about.

I just want to make clear that just because we are so close to July, you would not lose the benefit of acting if you acted by July 5, if there was an indication that you would act. The commercial banks would be reluctant to take in money which they would then have to let go at a later date because of a prohibition.

The CHAIRMAN. May I suggest this. If we cannot do something in the next 30 minutes, or 40 minutes, it will go over until after the recess. We have a recess commencing next Thursday that will last until the following Monday week, July 11. Unless we can get something agreed to today, we will be out of luck until after recess for consideration of it. We have today the question, first, whether or not we can try to resolve this thing by agreement and get something done now? As you say, it would have some influence, maybe—I do not know—and then next, if we do not do that, I would recognize Mr. Reuss to finish his amendments that he is presenting, and after that to recognize Mr. Todd who is moving to reconsider Mr. Weltner's amendment which established the 5-percent rate ceiling. Some members of our committee voted for that and would now like to change their mind and would like to vote for a lower rate. These questions are all up today and it will be impossible to consider them all. But if we do just agree on some 1- or 2-year bill and a certain rate, that will be possible.

Mr. STANTON. Mr. Sherbourne, would you not say that this commitee has done a great public service already in the month of hearings we have had? We have highlighted this problem. If we have no legislation before July 1, we are warning the Federal Reserve Board and bankers of our great interest in this subject and we put them on record that we think they really better do something. Do you not think we have already done a great service?

Mr. SHERBOURNE. You already have. Whether it is adequate or not I do not know.

The CHAIRMAN. They can do something to us but we cannot do anything to them.

Without objection, we will go into executive session.

(Whereupon, at 11:25 a.m., the committee proceeded into executive session, to reconvene subject to the call of the Chair.)

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APPENDIX

RECENT TRENDS IN COMMERCIAL BANK PROFITS

Applicable tax rate and net operating earnings on common stock of 7 New York City banks and 18 banks in other centers, 1960–65

[Dollars in millions]

12 months ending	Applicable tax rate (percent)	Net operating earnings on common stock
7 New York City banks:		
Dec. 31, 1965	33.8	$406.6
Dec. 31, 1964	38.1	375.2
Dec. 31, 1963	41.3	337.9
Dec. 31, 1962	43.2	328.2
Dec. 31, 1961	45.5	325.4
Dec. 31, 1960	48.5	336.7
18 banks in other centers:		
Dec. 31, 1965	36.3	454.2
Dec. 31, 1964	39.3	426.3
Dec. 31, 1963	42.3	387.2
Dec. 31, 1962	43.6	364.2
Dec. 31, 1961	46.5	374.4
Dec. 31, 1960	48.6	385.7
25 banks combined:		
Dec. 31, 1965	35.1	860.8
Dec. 31, 1964	38.7	801.5
Dec. 31, 1963	41.8	725.1
Dec. 31, 1962	43.4	692.4
Dec. 31, 1961	46.0	699.8
Dec. 31, 1960	48.6	722.4

Source: M. A. Schapiro & Co., Inc., New York, N.Y.

Applicable 1965 tax rate of 50 selected commercial banks, listed in order of common capital accounts on Dec. 31, 1965

[Dollars in millions]

Bank	Capital accounts	
	Common, Dec. 31, 1965	Applicable tax rate (percent)
1. First National City Bank	$999.5	28.44
2. Bank of America National Trust and Savings Association	891.9	44.00
3. Chase Manhattan Bank, National Association	879.6	33.80
4. Morgan Guaranty Trust Co	642.6	40.16
5. Chemical Bank New York Trust Co	521.4	28.16
6. Manufacturers Hanover Trust Co	521.1	37.37
7. Continental Illinois National Bank & Trust Co. of Chicago	409.7	35.23
8. First National Bank of Chicago	404.7	36.11
9. Mellon National Bank & Trust Co	362.2	14.05
10. Bankers Trust Co	360.7	36.87
11. Security First National Bank	321.7	32.65
12. Wells Fargo Bank, San Francisco	264.7	35.90
13. First National Bank of Boston	254.1	48.53
14. Crocker-Citizens National Bank	211.7	30.60
15. National Bank of Detroit	208.5	22.36
16. Irving Trust Co	185.1	34.33
17. Cleveland Trust Co	175.8	29.42
18. First Pennsylvania Banking & Trust Co	127.3	41.91
19. Republic National Bank of Dallas	123.6	33.83

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Applicable 1965 tax rate of 50 selected commercial banks, listed in order of common capital accounts on Dec. 31, 1965—Continued

[Dollars in millions]

Bank	Capital accounts	
	Common, Dec. 31, 1965	Applicable tax rate (percent)
20. Pittsburgh National Bank	$113.5	24.44
21. Seattle-First National Bank	112.6	35.93
22. Philadelphia National Bank	110.2	36.89
23. Detroit Bank & Trust Co	109.0	26.23
24. Harris Trust & Savings Bank	98.8	35.43
25. National City Bank of Cleveland	97.7	34.75
26. First National Bank of Dallas	97.3	33.81
27. Northern Trust Co., Chicago	94.7	27.93
28. Girard Trust Bank	93.8	38.06
29. United States National Bank of Ohio	90.8	41.08
30. Wachovia Bank & Trust Co	82.3	40.12
31. Union Bank, Los Angeles	82.1	42.75
32. Bank of New York	76.6	44.81
33. Franklin National Bank	74.7	16.12
34. Provident National Bank	73.7	34.52
35. Manufacturers National Bank of Dayton	70.7	19.22
36. Bank of California, National Association	69.1	29.40
37. Fidelity-Philadelphia Trust Co	68.7	34.77
38. State Street Bank & Trust Co	67.9	44.42
39. Valley National Bank of Arizona	65.8	38.13
40. Central National Bank of Cleveland	63.7	28.67
41. Citizens & Southern National Bank	63.6	35.15
42. Indiana National Bank	58.1	32.02
43. County Trust Co	54.9	12.81
44. First National Bank of Atlanta	52.2	34.84
45. Industrial National Bank of Pittsburgh	51.3	17.49
46. First National State Bank of New Jersey	48.2	28.21
47. American Fletcher National Bank & Trust Co	46.6	38.44
48. First National Bank of Memphis	40.0	25.10
49. American Security & Trust Co	39.8	47.47
50. American National Bank & Trust	38.3	37.10
Composite, 50 banks	10,072.6	34.91

Source: M. A. Schapiro & Co., Inc., New York, N.Y.

[From Bank Stock Quarterly, March 1966, pp. 2–4]

How Banks Are Doing

With more money working more profitably, many commercial banks this year will report greater gains in net operating earnings than in 1965.

Profit margins per dollar of loans and investments are recovering from last year's sharp squeeze. In 1965 banks were paying more for funds while unable to raise their lending rates. Growth in earnings lagged, although growth in loans accelerated. Today, however, prevailing interest rates on loans and on securities are considerably above the returns realized last year. Portfolio yields are improving daily as new loans and investments are made and old assets replaced at going rates. Rising operating revenues are absorbing the larger interest payments on time deposits and borrowed money.

First-quarter net operating earnings of 25 major banks centered in 12 principal cities across the country show an aggregate increase of eight per cent over the same period a year ago. Individual bank results range from minor gains to as great as 25 per cent. These comparisons are after interest on capital notes and applicable taxes, but before charge-offs and recoveries on loans and before losses and gains on securities.

1965 PROFIT MARGIN—$10.19

Gains in net operating earnings should improve with each quarter as profit margins continue to strengthen. This, of course, is subject to any increase in the corporate tax rate, although the impact of higher levies would be lessened

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for banks because of their holdings of tax-exempt securities. The profit margin—expressed in dollars and cents per thousand dollars of loans and investments—is the excess of the yield realized on total loans and investments over the yield required to break even, adjusted for applicable income taxes. Last year's net operating earnings of the 25 banks were $861 million—the product of loans and investments totaling $84.8 billion and a profit margin per thousand dollars of $10.19.

The yield required to break even will move up substantially from last year's 3.35 per cent because of larger interest payments. These costs cover interest on passbook accounts, savings certificates, negotiable certificates of deposit, and other time deposits; also, interest on borrowed funds including rediscounts, federal funds purchased, short-term promissory notes, and capital notes. Of the 3.35 per cent the amount attributable to expenses other than interest is expected to decline from the 1.24 per cent in 1965.

ASSET YIELDS MOVE UP

Interest income earned in 1966 will reflect the higher yield realized on a greater volume of total loans and investments. The increase this year in bank credit outstanding will be less than the record expansion of 1965. Short-term yields and bank lending rates, however, have moved up substantially from the levels of last year. These developments are consistent with the Federal Reserve's policy of containing inflationary pressures in the economy. The six-month Treasury Bill yield in the 13 weekly auctions thus far this year has averaged 4.98 per cent coupon equivalent, compared with 4.12 per cent for the same period a year ago. The prime rate, raised on December 6 by The First National Bank of Chicago to 5 per cent from 4½ per cent, was again increased by Morgan Guaranty Trust Company on March 10 to 5½ per cent.

Last year the yield realized by the 25-bank group on their combined loans and investments was 4.92 percent, the resultant of loans at 5.47 per cent and investments at 3.50 per cent. The latter rate reflects the presence of tax-exempt income. As indicated in bank reports, the higher cost of funds is quickly reflected in operating expenses; higher returns on earning assets are realized more slowly.

If the after-tax profit margin of the 25 banks should recover to the $10.54 recorded in 1964, an expansion of seven per cent in total loans and investments from the 1965 level would produce net operating earnings of $950 million. This would represent a gain of more than ten per cent from the $861 million earned last year.

The pace of credit expansion is slowing. In 1965 total domestic loans and investments of the 344 weekly reporting member banks averaged $157.9 billion, an increase of ten per cent over the $143.5 billion in 1964. These are banks having deposits of more than $100 million. In the first 12 weeks of 1966, the level of credit outstanding moved up $7.8 billion or five per cent above last year's 52-week average. This year's growth rate is certain to be contained by today's tighter position and more restrictive monetary controls.

Lending and investing policies are restrained by the rise in the ratios of loans to deposits, liquidity needs, increased competition for funds, and the ever-sensitive certificates of deposit. The cumulative effects of tight money were intensified further by the incessant demand for loans which continued even after December 5 when the Federal Reserve raised the discount rate from 4 to 4½ per cent and lifted the maximum permissible rate banks could pay on time deposits from 4½ to 5½ per cent. Banks are borrowing constantly while searching all markets for new deposits.

BANKS BUILD RESERVES

The unprecedented expansion in loans in 1964 and 1965 coupled with the new Treasury regulations issued last year have enabled banks to enlarge substantially their reserves for possible loan losses. For tax purposes banks are now permitted to create such reserves equal to 2.4 per cent of eligible loans outstanding at year-end. Loan loss reserves normally are augmented by transfers from earnings and by related tax savings. Losses are charged to these reserves; recoveries are credited.

The loan loss reserves of the 25-bank group totaled $1,462 million on December 31, 1965. This is a net increase of $218 million or 17.5 per cent from the $1,244 million on December 31, 1964. The seven New York City banks accounted for $143 million of the increase.

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Transfers to loan loss reserves may bear little relation to current loss experience. To illustrate, in the past six years the seven New York City banks transferred $530 million to these reserves. In the same period, however, loan losses net of recoveries were $173 million.

The common capital accounts of the 25-bank group totaling $8,496 million at year-end 1965 were buttressed by aggregate loan loss reserves of $1,462 million.

A bank is no better than the quality of its loans. Liabilities are certain; assets not. Capital protects deposits, so do loan loss reserves. At a time when loan demands are high, stockholders rightfully may ask, "Are earnings sufficient to provide adequate additions to capital and reserves?"

Reserves for possible loan losses

[In millions of dollars]

	Dec. 31			Percent increase 1964-65
	1963	1964	1965	
7 banks in New York City:				
Bankers Trust Co	23.5	25.4	47.4	86.6
Chase Manhattan Bank, N.A	154.6	167.5	213.5	27.5
Chemical Bank New York Trust Co	40.5	43.9	66.6	51.7
First National City Bank	143.0	159.0	183.0	15.1
Irving Trust Co	18.7	19.7	29.9	51.8
Manufacturers Hanover Trust Co	116.5	133.6	133.0	−0.4
Morgan Guaranty Trust Co	34.8	36.8	59.4	61.4
Total	531.6	589.5	732.8	24.3
4 banks in California:				
Bank of American National Trust and Savings Association	153.2	161.7	170.0	5.1
Crocker-Citizens National Bank	33.9	40.2	44.5	10.7
Security First National Bank	32.6	37.6	47.4	26.1
Wells Fargo Bank	20.9	22.0	31.1	41.4
Total	240.6	261.5	293.0	12.0
14 banks in other centers:				
Cleveland Trust Co	14.7	16.4	19.4	18.2
Continental Illinois National Bank & Trust Co	99.0	120.0	121.9	1.6
Detroit Bank & Trust Co	5.7	7.2	11.3	56.9
First National Bank of Boston	31.0	25.8	31.2	20.9
First National Bank of Chicago	55.5	76.2	79.3	4.1
First Pennsylvania Banking & Trust Co	27.8	28.8	29.0	0.7
Girard Trust Bank	12.1	12.9	15.4	19.4
Mellon National Bank & Trust Co	10.2	12.1	16.1	33.1
National Bank of Detroit	17.0	19.7	30.9	56.9
Philadelphia National Bank	23.7	27.4	27.3	−0.4
Pittsburgh National Bank	11.9	13.7	17.4	27.0
Republic National Bank of Dallas	20.1	19.8	19.8	
Seattle-First National Bank	8.2	8.7	10.7	23.0
United States National Bank of Oregon	3.3	4.4	6.2	40.9
Total	340.2	393.1	435.9	10.9
Total 25 banks	1,112.4	1,244.1	1,461.7	17.5

[From the Monthly Review, April 1966, pp. 75-81]

BANK PROFITS: ANOTHER RECORD

Commercial banks overcame a tough series of obstacles in 1965 to reach a record level of profits. The net current operating earnings record was somewhat mixed; member banks nationally registered a 4.6-percent increase over the preceding year, but member banks in the Twelfth Federal Reserve District experienced a slight reduction from their 1964 peak in net current operating income before taxes. However, District banks had smaller non-operating losses and lower Federal taxes than in the previous year, and thereby attained a new peak

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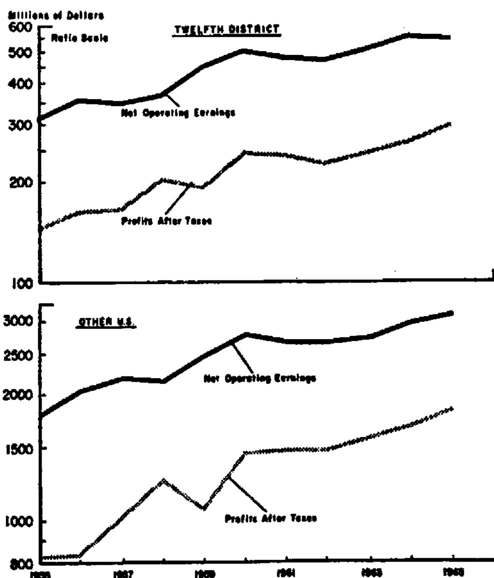
of $306 million in after-tax profits. The 14-percent year-to-year increase was well above the national rate of gain in after-tax income.[1]

The major hurdle banks faced in 1965 was a familiar one—increased costs on time and savings deposits. At the beginning of last year, most District banks raised their interest rates on passbook savings to the 4-percent maximum permitted under the November 1964 revision of Federal Reserve Regulation Q, and they also offered higher rates on other time deposits. As a result of these higher rates and the large volume of deposits they attracted, District banks paid out 25 percent more in the form of interest than they did in 1964. Furthermore, because of the November 1964 increase in the discount rate and the general upward trend in money market rates which followed, banks also experienced a sharp increase in the cost of their borrowed funds.

On the revenue side, a major factor inhibiting higher income was the maintenance of the prime rate for commercial borrowers at 4½ percent until the last month in the year. The stability of this pivotal rate during most of 1965 tended to retard the upward movement of bank loan rates generally. In addition, a somewhat tighter monetary policy, together with a higher loan-to-deposit ratio and a lower ratio of short-term securities to deposits, reduced banks' flexibility to shift into higher-earning, longer-term assets. Yet, in spite of these obstacles, the overall gain in District-bank operating revenues fell only $11 million short of the $254 million increase in expenses.

District banks' current earnings
level off but after-tax profits rise



In the area of non-operating income, District member banks encountered some favorabe factors last year. A realization of net recoveries and profits on securities contrasted with losses in this category in 1964, and transfers from security-valuation reserves increased. Moreover, District banks generally benefited from the new Internal Revenue Service regulation regarding reserves for bad debts. Tax savings from this source and from larger holdings of tax-exempt securities, together with the reduction in Federal income tax rates from 50 percent to 48 percent, materially assisted District banks in achieving record after-tax profits.

[1] Because a number of banks made changes in their accounting procedures in 1965, comparisons with 1964 income data are not strictly comparable. In particular, these changes tend to increase reported current revenue on securities and to reduce security valuation reserves.

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Earnings and expenses of 12th district member banks

[Millions of dollars]

	1965 p	1964
Earnings on loans	1,772.0	1,592.3
Interest and dividends on—		
U.S. Government securities	236.4	240.4
Other securities	157.7	123.5
Service charges on deposit accounts	176.0	160.9
Trust department earnings	73.3	70.5
Other earnings	85.4	70.3
Total earnings	2,500.8	2,257.9
Salaries and wages	581.3	543.9
Interest on time deposits	885.7	708.6
Other expenses	480.9	442.3
Total expenses	1,948.5	1,694.8
Net current earnings	552.3	563.1
Net recoveries and profits (— losses) [1]:		
On securities	+14.6	−12.2
On loans	−102.2	−90.9
Other	−10.7	−20.8
Total net recoveries and profits (— losses) [1]	−98.3	−123.9
Net profits before income taxes	454.1	439.2
Taxes on net income	147.8	169.6
Net profits after taxes	306.3	269.6
Cash dividends declared	173.7	161.8

p Preliminary.
[1] Includes transfers to (−) and from (+) valuation reserves.

NOTE.—Details may not add to totals due to rounding.

Source: Federal Reserve Bank of San Francisco.

But banks in the West, as elsewhere, will not be able to rest on their well-earned laurels. Once again, in 1966, they face the effects of a rise in interest rates on time deposits—a rise stemming from a further revision in Regulation Q in December 1965. In contrast to the situation which prevailed a year ago, however, this year's increase (barring any further changes in "Q") will not reflect higher rates on passbook savings—the major component of District banks' interest-bearing deposits—since the maximum permissible rate remains at 4 percent. Yet the higher rates being offered on other time deposits, including savings certificates and bonds, will further increase interest expense on deposits even if their volume remains stable. And if, as appears increasingly to be the case, the volume of bank savings certificates and bond increases at the expense of passbook savings, interest costs will increase even more.

On the other hand, a number of factors affecting bank revenues appear to be more favorable in 1966 than they were last year. The increase in the prime rate, first to 5 percent in early-December 1965 and then to 5½ percent in March 1966, and the higher rates of return on loans generally, should place banks in a better position this year to offset added interest and other costs. Nonetheless, high loan-deposit ratios, possible further reductions in security holdings (which could involve substantial losses because of price declines), and continued reserve pressure, may tend to limit further gains in net operating earnings and profits.

BUSINESS DEMANDS BOOST LOAN REVENUES

Total operating revenues of District member banks rose 11 percent in 1965, and lending officers brought in nearly three-fourths of this increase, in the form of interest, discounts, and other loan charges. However, most of this higher revenue came from an expansion in loan portfolios, inasmuch as the average rate of return on loans increased by only 3 basis points.

The relatively stable rate of return on loans was related to developments in the business-lending field. For the second consecutive year, business loans accounted for the major part of the loan increase, and an unusually high percentage of the dollar amount of such loans made in metropolitan areas last year carried the old prime rate of 4½ percent. In view of this situation, the spread narrowed between the average rate of return on loans and the average rate of interest paid on time deposits.

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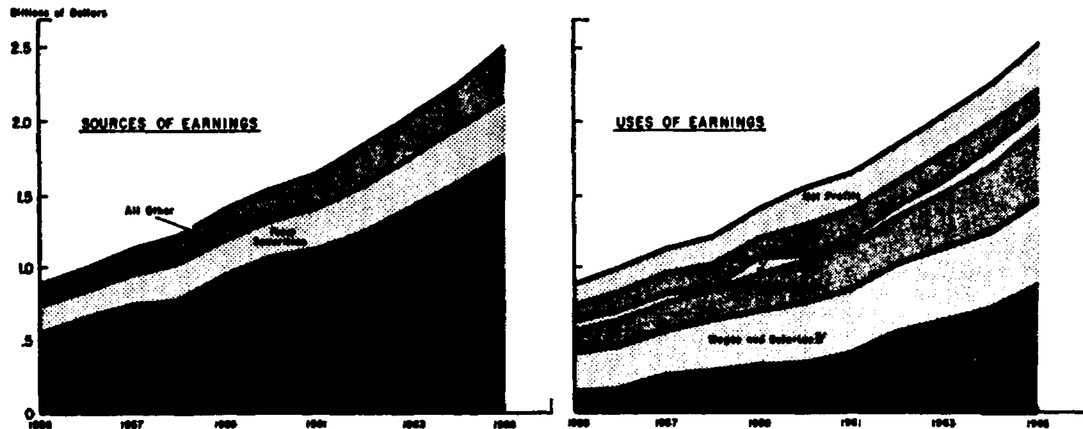
Strong gain in earnings caused by expansion of loan portfolios . . .
revenue gain again offset by rising cost of time deposits



[1] Net losses on securities and loans including transfers to and from valuation reserves.

[2] Beginning in 1961, this item excludes wages and salaries of those officers and employees who spend the major part of their time on bank building and related housekeeping functions. Those expenses thereafter are included in "other expenses."

In 1965, as a year earlier, District banks held the increase in their mortgage portfolios to slightly under 7 percent. At the same time, a number of major banks sold substantial amounts of real estate loans out of their portfolios to a wide-range of institutional investors, but, as is customary in this type of transaction, the banks retained the servicing of the loans. Several District banks also acquired mortgage companies during the year. These transactions were reflected in a 20-percent increase in revenues from the category "other charges on loans" (which includes fees for servicing).

In one major loan category—consumer credit—banks failed to match their 1964 performance. High-yield consumer installment loans rose, but not at the same pace as in the preceding year, mainly because the sluggishness of District auto sales brought about a reduced rate of growth in auto credit.

MUNICIPALS ADD TO REVENUES

District member banks' revenue from securities rose 8 percent in 1965.[1] On U.S. Government securities a 9-percent reduction in the volume of holdings more than offset a 17-basis-point rise in the average rate of return. Consequently, revenue from Treasury issues fell 2 percent below the amount received in 1964. In contrast, income on other securities—mainly tax-exempt municipals—soared 28 percent as bank holdings of these issues increased by nearly one-fourth and the average rate of return rose 28 basis points. As in other recent years, banks expanded their holdings of municipals to take advantage of their relatively high after-tax yields.

District bank income in 1965 also reflected increases from all other revenue sources—service charges on deposits, other charges and fees, trust-department operations, and miscellaneous operations.

HIGH INTEREST COST HURDLE

The cost of interest on time and savings deposits dominated bank expenses in 1965. Interest payments by District member banks rose by one-fourth to a record-shattering $886 million—and this accounted for over one-fifth of total interest payments made by all member banks in the U.S. Higher costs resulted from a combination of a 13-percent rise in the volume of interest-bearing deposits and an increase in the average interest rate paid on such deposits, from 3.53 percent in 1964 to 3.92 percent in 1965. About half of the gain in these deposits occurred in time certificates—both savings certificates and negotiable CD's—as banks offered rates above the 4-percent maximum permitted on passbook savings in an effort to attract funds to meet increasingly strong loan demands.

Selected operating ratios of 12th district member banks

[Percent ratios]

	1965	1964	Increase or decrease
Earnings ratios:			
Return on loans	6.40	6.37	+.03
Return on U.S. Government securities	3.75	3.58	+.17
Return on other securities	3.28	3.00	+.28
Current earnings to capital accounts	16.03	18.13	−2.10
Net profits after taxes to capital accounts	8.89	8.69	+.20
Cash dividends to capital accounts	5.04	5.22	−.18
Other ratios:			
Interest paid on time deposits to time deposits	3.92	3.53	+.39
Time deposits to total deposits	53.33	50.78	+2.55

NOTE.—The ratios in this table are computed from aggregate dollar amounts of earnings and expense items of 12th district member banks. Capital accounts, deposits, loans, and securities items on which these ratios are based are averages of call report data as of Dec. 20, 1963, June 30, 1964, and Dec. 31, 1964; and as of Dec. 31, 1964, June 30, 1965, and Dec. 31, 1965.

Source: Federal Reserve Bank of San Francisco.

[1] Since some banks in 1965 reported accretion of discounts on U.S. Treasury securities and/or municipal securities as current revenue for the first time, the increase from 1964 in the average rate of return on securities tends to be overstated.

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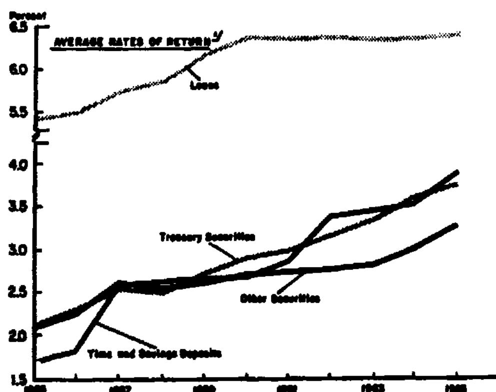
Another steeply rising expense item in 1965 was the cost of borrowed money. A 50-percent increase in this category reflected daily average borrowing of $12 million at the San Francisco Federal Reserve Bank and an additional daily average of $81 million in net interbank purchases of Federal funds. On this substantially larger volume of borrowing, District banks paid higher rates of interest than in 1964—both at the discount window and in the Federal-funds market.

On other major expense items, banks were able to keep a tight rein for the second consecutive year. The increase in officer and employee salaries and in fringe benefits was $10 million less than the 1964 increase. Net occupancy and other current expenses also rose at a slower pace. The smaller rate of increase in these expense items reflected a decline in the numbr of new bank openings (18 in 1965 as against 47 in 1964) and a decline in the number of new branch offices (185 vs. 191). Automation, plus a generally increased emphasis on overall operating efficiency, also served to reduce the number of new employees required to man new and existing offices.

Average rate paid on time deposits exceeds return on Governments



[1] Ratios for the 1955-62 period are based on the averages of five call reports (December, Spring, June, Fall, and September), and for the 1963-65 period are based on the averages of three call reports (December, June, and December).

RECORD NET INCOME

Current operating revenues of District banks exceeded expenses by $552 million—$11 million less than in 1964. Yet net income before taxes exceeded the 1964 gain by $15 million, because banks recorded net profits and recoveries on securities instead of losses as in the preceding year. In 1965, total recoveries and profits on securities just slightly offset losses, when losses and charge-offs credited to security valuation reserves are included.

Net loan losses, on the other hand, exceeded those of 1964—reaching a total of $56 million, when charge-offs to bad debt and other loan reserves are included. In addition, net transfers to loan reserves were $101 million, about $10 million more than in 1964. Many District banks found the new Internal Revenue formula for computing bad debt reserves for loans to be more advantageous than the old formula based upon an individual bank's loan-loss experience; consequently, they increased their reserves by the maximum allowable amount in order to realize added tax savings.

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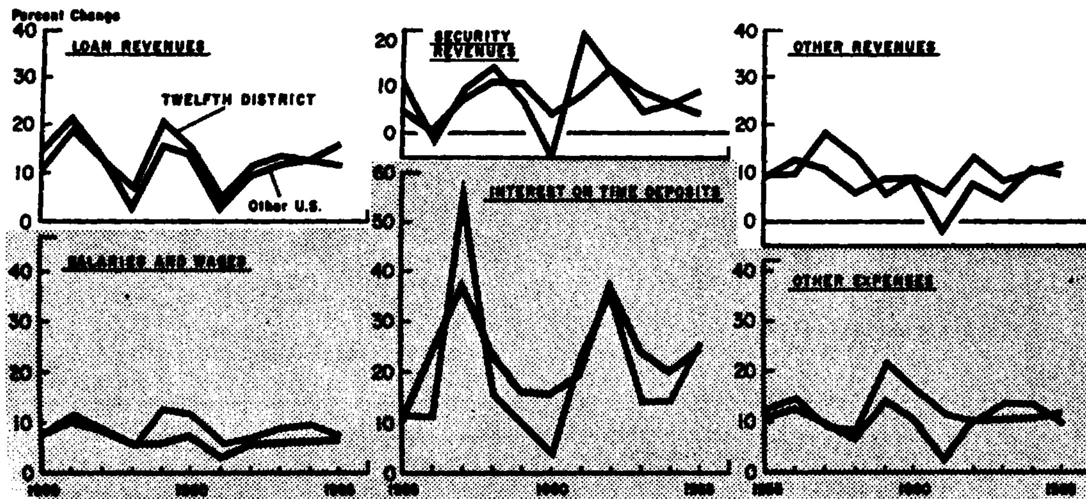
Loan revenues rise more slowly at District banks than elsewhere . . .
both groups of banks show sharp rise in time-deposit interest expense



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In 1965 District member banks paid $22 million (17 percent) less in Federal taxes on net income than in 1964; this reduction far offset a $1-million (4-percent) increase in state tax payments. Lower Federal taxes resulted from a reduction in the tax rate, an increase in holdings of tax-exempt securities, and larger tax-free bad-debt reserves. Consequently, District member banks received $306 million in after-tax net income, or 14 percent more than in the previous record year (1964).

Cash payments made by District banks, in the form of dividends and interest on capital notes and debentures, totaled $174 million—7 percent more than in 1964. The increase in the member-bank universe and some raising of dividend rates on common stock contributed to this gain. The largest part of the increase, however, came from interest on capital notes and debentures, which is reported together with dividends on preferred stock; this combined item of capital cost rose from under $1 million in 1963 to nearly $15 million in 1965. (District banks had $336 million in outstanding capital notes and debentures as of year-end 1965.) In spite of a sizable increase in total capital accounts in 1965, the ratio of net profits to capital accounts was 8.91 percent, up from 8.69 percent in 1964, and one basis point above the ratio nationally.

Selected resource and liability items of all member banks, 12th district, 1965

[Millions of dollars]

	As of Dec. 31, 1965 [1]	Change from Dec. 31, 1964	
		Dollar	Percent
Net loans and investments	40,450	+3,252	+8.7
Loans and discounts, net [2]	29,100	+2,870	+10.9
Commercial and industrial loans	10,060	+1,465	+17.0
Agricultural loans	1,240	+116	+10.3
Real estate loans	9,291	+585	+6.7
Loans to individuals	5,771	+623	+12.1
U.S. Government obligations [3]	6,177	−589	−8.7
Other securities	5,173	+971	+23.1
Total assets	49,094	+3,039	+6.6
Total deposits	43,778	+2,507	+6.1
Demand deposits	19,828	−274	−1.4
Total time and savings deposits	23,951	+2,781	+13.1
Savings	17,189	+1,450	+9.2
Capital accounts	3,550	+226	+6.8

[1] Preliminary.
[2] Total loans minus valuation reserves. Selected loan items which follow are reported gross.
[3] Includes obligations guaranteed by the U.S. Government.

NOTE.—Details may not add to totals because of rounding.

Source: Federal Reserve Bank of San Francisco.

Several differences showed up last year between the performance of the 12 largest District banks (deposits of $500 million and over) and that of the remaining District banks. These data are aggregates, of course, as are the other data in this article; there were even wider variations in performance on an individual-bank basis.

Net current operating earnings of the large banks fell almost 3 percent short of their 1964 record high, whereas the remaining banks increased their net operating earnings by nearly 2 percent. On non-operating income the situation was reversed, with the large banks showing higher net income before taxes than in 1964 and the other banks a net decline from the preceding year. The 12 largest banks also reported a 16-percent increase in after-tax profits, compared with a less than a 4-percent rise for the other-bank group, even though the latter benefited more from lower taxes.

1966?

The growth in time certificates—particularly those offered to individuals—is likely to continue at an even faster rate in 1966, since an increasing number of District banks are aggressively seeking such deposits. And, since the rates offered on these deposits are already higher than those prevailing in 1965, the cost of interest is likely to be higher than last year. However, recent develop-

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ments indicate the likelihood of a continued strong demand for credit from the business sector—and thus continued upward pressure on loan rates as well.

On the other hand, mortgage-loan demand is not expected to change materially this year, barring any substantial recovery in housing activity. In fact, with loan-deposit ratios rising further in early 1966, banks may well continue to sell mortgages out of their still relatively heavy real-estate portfolios, so as to obtain funds for relending and to further increase their revenues from loan-servicing fees. In the consumer-loan field, the steadily rising flow of repayments from consumer instalment loans made in preceding periods may limit banks' ability to expand their outstanding consumer loans as rapidly as they did in earlier years. For this reason, the consumer sector in 1966 may not provide banks with as much additional revenue as heretofore. But firmer loan rates may offset, at least to some extent, the effect on revenues of any slowdown in the rate of growth in consumer financing.

Percent changes in selected earnings and expense items of 12th district member banks

	All		12 largest [1]		Other	
	1964–65	1963–64	1964–65	1963–64	1964–65	1963–64
Earnings on loans	+11.3	+12.6	+10.9	+12.1	+12.9	+14.8
Interest and dividends on securities	+8.3	+5.6	+8.4	+5.1	+8.0	+7.7
U.S. Government	−1.7	+.5	−2.6	−.7	+1.6	+5.2
Other	+27.7	+17.5	+28.6	+17.8	+24.0	+14.8
Service charges on deposit accounts	+9.4	+6.9	+9.5	+7.0	+9.0	+7.0
Trust department earnings	+4.0	+12.4	+2.6	+12.9	+13.0	+9.5
Other earnings	+21.5	+10.4	+18.5	+7.9	+31.0	+20.6
Total earnings	+10.8	+10.9	+10.4	+10.5	+12.3	+12.9
Salaries and wages	+6.9	+8.8	+14.2	+8.0	+9.8	+12.3
Interest on time deposits	+25.0	+13.4	+25.2	+13.2	+23.9	+14.6
Other expenses	+8.1	+12.7	+6.6	+11.0	+12.6	+18.9
Total expenses	+15.0	+11.7	+14.8	+11.0	+15.8	+15.0
Net current earnings	−1.9	+8.6	−2.7	+9.0	+1.6	+6.8
Net profits before income taxes	+3.4	−.3	+5.3	−1.0	−4.1	+2.6
Taxes on net income	−12.9	−11.9	−12.1	−13.6	−16.0	−4.7
Net profit after taxes	+13.6	+8.2	+16.0	+8.8	+3.6	+5.9
Cash dividends declared	+7.4	+11.4	+6.7	+11.0	+9.7	+14.1

[1] Includes all district member banks with total deposits of $500,000,000 and over as of Dec. 31, 1965.

Source: Federal Reserve Bank of San Francisco.

In the face of sharply rising yields on both Treasury issues and municipals, District banks so far in 1966 have reduced their total security holdings more than seasonally (particularly U.S. Treasury issues) in order to accommodate loan demands. Therefore, in spite of higher rates of return, revenue from securities this year may not equal last year's level. Banks also face the added possibility of substantial losses on sales of securities acquired at higher prices.

As the year progresses and money market conditions alter and credit demands shift, banks undoubtedly will need to make use of all the experience gained during the last several years of financial innovation and change to meet these new challenges.

[From the New England Business Review, May 1966, pp. 2–7]

Bank Loan Losses, Past and Present

"All economic indicators are go" might well be the slogan as the economy proceeds on its sixth year of sustained expansion. Personal incomes are high, corporate profits are up and liquid asset holdings are at record levels. One must search carefully indeed to find any signs of weakness.

One area, however, has shown a contrary trend, namely losses on bank loans to business and consumers. While the loss rate on bank loans is still at low levels, it has nevertheless been rising over the past decade. This article investigates various facets of bank loan losses. Questions considered are: the relation of bad loans to the business cycle, the types of loans that go bad, and finally the significance of losses to the general quality of bank credit.

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HISTORY OF LOAN LOSSES

Shown on Chart 1 are annual loss rates on commercial bank loans from 1919 to the present. The highest loss rates occurred during the great depression of the 1930's, when the net charge-off of loans amounted to over $3 for each $100 of loans outstanding. This loss rate was over 5 times the average rate of the 1920's and over 20 times the current rate of about 15 cents per $100 of outstanding loans.

During World War II the net loss rate actually fell below zero as recoveries on loans previously considered losses exceeded those being currently charged off. After the war the net loss rate began to rise somewhat as charge-offs rose and recoveries declined. In 1960 the loss rate rose rather sharply to a higher level which has been maintained in the last 4 years.

LOAN LOSSES LEAD THE CYCLE

One peculiarity in the behavior of loan losses is that they often lead the general business cycle. As shown in Chart 1, the loan loss rate usually hits a peak a year or more before the onset of recessions and depressions. In the postwar period, for example, loan losses were at peaks in 1953, 1956, and 1960. Recessions followed these peaks in 1954, 1958, and 1961.

This lead of bank loan losses is not easy to explain. It would be expected that loan losses would be highest during recessions when the business outlook is the worst. In fact, we might expect loan losses to lag behind recessions somewhat since loan officers need some time to recognize that a loan is not going to be repaid and should be charged off the books.

Loans usually are not considered to be in trouble until one or more interest payments or instalments have been missed. Even then, the loan is first classified as being in default rather then being written off as uncollectable. Therefore we would normally expect loan repayments to be missed in the bottom of a recession and only later would steps be taken to make the charge-off.

The lead of loan losses ahead of business conditions is matched by the lead of a broader bad loan series termed liabilities of business failures. This liability series is classified as one of 12 economic indicators which usually lead the general business cycle. Evidently the tendency of credit to turn sour before recessions reflects something basic rather than simply being an oddity.

Several possible explanations of the lead of loan losses can be advanced. First, changes in business profits usually precede changes in general economic activity and loan losses are obviously closely related to business profits and losses. Business profitability is usually determined more by growth of sales than by the level of sales. If sales are not rising, profit margins tend to decline even though the level of sales remains high as capacity is increased in the given industry and competition intensifies.

Loan losses may also reflect the circumstances under which the bad loans were initially made. In the expanding phase of the business cycle banks are usually well supplied with funds and are actively seeking loan outlets. Optimism is high so loans of less than good quality may be made. These loans may turn sour fairly soon if the borrowers encounter any operating difficulties. Thus the loan losses of 1953, 1956, and 1960 may well reflect some poor lending judgment in the boom years of 1952, 1955 and 1959.

The loan loss series behaved quite differently during the 1920's. The short but severe depression of 1920–22 quadrupled the net loss rate, up to .80 percent from .20 percent in 1919. During the remainder of the decade the loss rate declined until 1928, then rose somewhat in 1929. After the stock market crash of October 1929, however, loan losses shot up rapidly.

TYPES OF LOANS GOING BAD

Bank loans may be classified into three broad categories: business including commercial paper and financial loans, consumer, and real estate mortgage. Unfortunately adequate information is not available about the loss rate of the various types of loans. But there are some indications about the relative losses of the different types.

Consumer loans have by far the worst reputation so far as losses go, but this reputation is not entirely justified. Loss rates of bank consumer loans seem to have averaged only slightly higher than those of business loans, and both loss

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rates are very low, below 0.5 percent, or an average loss per year of less than 50 cents per $100 of outstanding loans. It should be noted, here, however, that banks generally take the "cream" of consumer loans and their losses—and their rates—are much lower than those of small loan companies, for example.

We would expect business loans to be the safest type of bank loan because borrowing by business is typically a small part of its total capital and liabilities. There is usually an adequate cushion of equity behind these loans. Despite this, their loss rate is substantially above that of mortgage loans.

Banks generally try to terminate loans to businesses which are becoming poor risks because of operating losses or other adversities. Sometimes the borrower is able to conceal evidence of his deteriorating position, and by the time the bank becomes aware of the situation, it is too late. The recent "vegetable oil" case was a dramatic example of successful concealment of a bad credit position. Except during depressions, larger business loan losses often involve some degree of deceit.

Real estate mortgage loans have the longest average maturities of any category of bank loans and might be judged to be less safe for that reason. But in the postwar period at least, real estate values have been rising along with prices in general, and thus the security behind mortgage loans has usually been adequate. While mortgage loans are also generally reduced (amortized) by instalment payments, this method of loan reduction does not appreciably reduce the loan balance in the early years of the mortgage. Since a large percentage are paid off or renewed within 10 years, most mortgages outstanding are in the early years of their terms. As a result, amortization is not as significant a safety feature for the majority of mortgages as is commonly supposed.

The danger in mortgage loans appears when real estate values begin to decline as in the latter 1920's. As mortgages are foreclosed, real estate is placed on the market and prices go down further. Price declines are likely to be especially severe in the case of apartment houses, office buildings, and other commercial real estate when overbuilding is followed by a recession.

Thus, even though mortgage loans have a good record during normal times, they become quite vulnerable if the real estate market goes into a decline. Their safety depends more on the value of the property than on the income of the borrower. Business loans stand in rather marked contrast in that they have a somewhat worse loss rate during normal times but tend to be sounder during business declines. Their safety depends mainly on the continuing income of the borrower which generally is large compared to the size of the loan.

Another factor which tends to make business loans safer assets than mortgages is their respective relationships to demand and time deposits. Business loans and demand deposits are both in the commercial side of banking. The extension of a business loan creates a demand deposit and, furthermore, businesses generally maintain a demand deposit, or compensating balance, of 20 percent or so against their loans and lines of credit. This demand deposit serves as partial security for the loans. Conversely, from the viewpoint of the business borrower, the loan serves as partial security against the failure of the bank since the borrower could cancel part of his loan with his frozen demand deposit. Therefore, a business borrower need not make a "run" on the bank if it is in danger of insolvency.

By contrast, mortgage loans are typically "made with" time deposits and there is no similar offset relation in the savings side of commercial banking. While demand deposits do get drawn down during bad depressions, this reduction largely reflects the paying off of business loans. If time deposits are withdrawn during a crisis, however, no automatic parallel reduction occurs in mortgage loans. These loans must be sold off to provide funds for payment of time deposits. If house prices are declining at the same time, there will be almost no market for mortgages. That is, mortgage loans, unlike business loans, are not self-liquidating.

LOAN LOSSES DURING THE BANK CRISES

Loan losses were very high after 1930 during the depth of the depression. This was also the period of disastrous bank failures when one-third of the commercial banks in the United States failed or otherwise went out of business. To what extent did bad loans account for bank failures? Positive answers cannot be given, but some tentative estimates might be made from available evidence.

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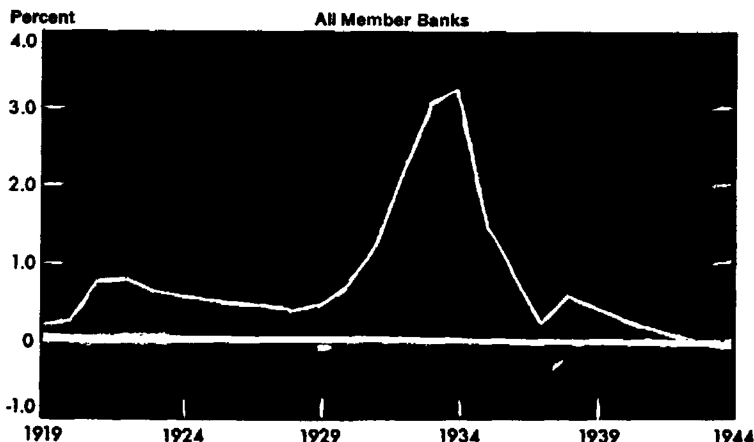
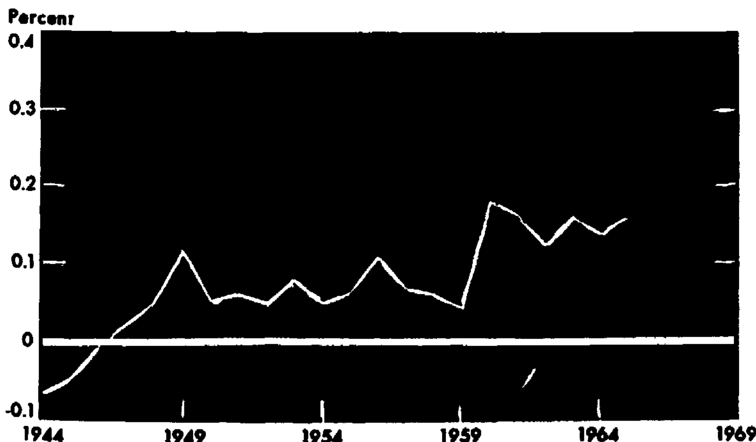
Chart 1

NET LOSS RATE ON BANK LOANS





SOURCE: Net losses are the excess of loan losses charged against profits and valuation reserves over actual recoveries. Net loan losses for the period before 1927 are estimates from gross loan losses based on the relationship between the two series during 1927–29.

As shown in Chart 1, the loan loss rate reached a level of about 3 percent. But this figure is misleading in that the level of outstanding loans declined by over 50 percent between 1930 and 1933, so the loss rate might be taken as only about 1–1½ percent of loans made. The years 1931–1934 were the bad loss years and cumulated net losses for the period came to about $2 billion. This was less than one-fourth of total bank capital of over $9 billion in 1930.

The depression problem was not actual default in loan repayments when due but the illiquidity of too large a proportion of bank loans and investments. As noted above, in this respect business and personal loans turned out to be a lot more liquid than mortgage loans. From 1930 to 1933, almost two-thirds of commercial bank loans other than real estate were liquidated providing more than enought funds in the aggregate in the commercial side of banking to match the decline in demand deposits. But in the savings side, only one-third of commercial bank mortgages were liquidated supplying less than $2 billion of funds, while time deposits declined by almost $9 billion. These factors probably largely explain why bank failures were concentrated among banks with larger than average ratios of time to total deposits and of mortgages to total loans.

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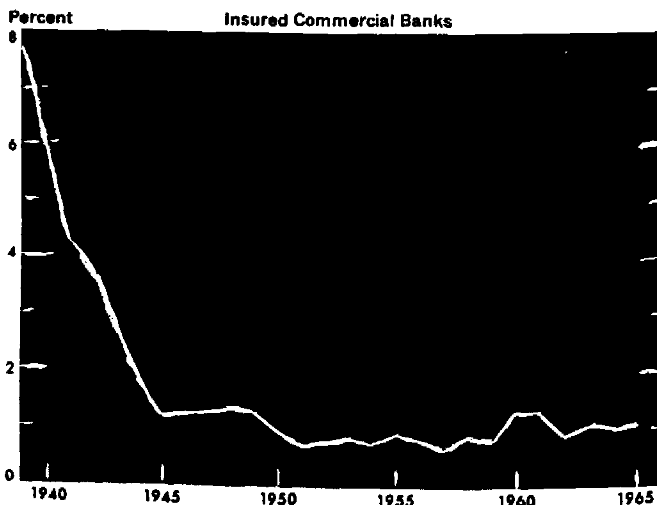
Savings and loan associations, with their heavy concentration of assets in mortgages, also suffered heavily during the depression. Mutual savings banks, however, did not fare badly despite their large holdings of mortgages. The favorable record of mutual savings banks is explainable in large part by their large average size and by their location in the northeast section of the Nation which had the lowest rate of bank failures. Mutual savings banks had an average of $15 million in deposits in 1930, while commercial banks had an average of only $2 million each. The six mutual savings banks that did fail between 1930 and 1933 had average deposits of less than $2 million.

The Northeast was fortunate in being less dependent on agriculture which was especially hard hit by low prices. Moreover general confidence in the region's banking system was greater as a result of its good historical record.

LOANS CLASSIFIED BY BANK EXAMINERS

Shown in Chart 2 is a history of loans classified as substandard by bank examiners from the three Federal Supervisory agencies: Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation. Detailed data on loan classification are not available, and the estimates used in Chart 2 are based on several fragmentry sources.

Chart 2
LOANS CLASSIFIED SUBSTANDARD AS A PERCENTAGE OF TOTAL LOANS



SOURCE: Calculated by the Federal Deposit Insurance Corporation for the period 1939–1951. Figures since 1951 are estimates from partial reports by the Federal Reserve System and the Comptroller of the Currency.

Banks examiners visit banks once or twice each year and one of their functions is to review the bank's loan portfolio. Loans considered of poor quality are classified as sub-standard, doubtful, or loss. A loan is rated "loss" if the examiner believes it is uncollectable. The bank is instructed to write off all loss loans. If a substantial loss is likely but the amount is not definitely ascertainable, a loan is classified as "doubtful." The remaining problem loans are classified as substandard. In the examiner's opinion they involve more than normal risk, but a loss does not appear likely. Of these total classified loans generally about 80 percent are "substandard," slightly over 10 percent "loss," and the remainder, "doubtful." Since individual consumer and mortgage loans are often too small to be considered by examiners, classified loans are primarily the larger business and mortgage loans.

The most dramatic feature of the chart is the decline in the ratio of substandard to total loans during World War II. This ratio was almost 8 percent in 1939 but by 1945 it was down to 1¼ percent. A further decline occurred during

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the Korean War when the substandard ratio fell to about ¾ percent. In 1960 the ratio rose to its present plateau of about 1 percent.

Only a small proportion of substandard loans become losses. During the past 10 years, for example, loan losses have been only about one-tenth as large as the amount classified as substandard. Normally a problem loan is first classified as substandard, then, if it continues deteriorating, as doubtful, and, finally, as loss. Since 1959 the net loss rate has almost tripled while the proportion of classified has gone up by only about 30 percent.

This discrepancy in rises between the net loss rate and percentage of substandard loans raises a question about the significance of these trends as an indication of the quality of bank credit. Has quality deteriorated in recent years as the rising loss rate suggests, or has it remained about the same as the ratio of substandard to total loans appears to indicate? It seems fair to conclude that, in case of doubt, the loss rate should be taken as the more accurate gauge of credit quality. Therefore it seems likely that some deterioration in the credit worthiness of bank borrowers has occurred since the 1950's. But relative to pre-war experience, bank loans are still of very good quality overall.

Depositary liabilities to the public commercial banks, mutual savings banks, and savings and loan associations

TIME AND SAVINGS DEPOSITS AND SAVINGS AND LOAN SHARES

End of—	Commercial banks	Mutual savings banks	Savings and loans	Total
	Billions of dollars			
1950	36.4	20.0	14.0	70.4
1960	72.1	36.3	62.1	170.5
1965	145.3	52.4	110.3	308.9
	Percentage shares			
1950	51.7	28.4	19.9	100.0
1960	42.3	21.3	36.4	100.0
1965	47.2	17.0	35.8	100.0

DEMAND PLUS TIME AND SAVINGS DEPOSITS AND SAVINGS AND LOAN SHARES

End of—	Commercial banks	Mutual savings banks	Savings and loans	Total
	Billions of dollars			
1950	130.2	20.0	14.0	164.2
1960	187.3	36.3	62.1	285.7
1965	280.3	52.4	110.3	443.0
	Percentage shares			
1950	79.3	12.2	8.5	100.0
1960	65.6	12.7	21.7	100.0
1965	63 3	11.8	24.9	100.0

Source: Federal Reserve Bulletin.

(Correspondence between Chairman Patman and Hon. William McC. Martin, Chairman of the Board of Governors of the Federal Reserve Board, concerning issuance of short-term promissory notes.)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., November 24, 1965.

Hon. WILLIAM MCC. MARTIN, Jr.,
Chairman, Board of Governors of the Federal Reserve System,
Washington, D.C.

DEAR CHAIRMAN MARTIN: It is very disturbing to note that the September 1965 issue of the *National Banking Review*, a periodical published by the Bureau of the Comptroller of the Currency, contains a ruling by Comptroller Saxon that

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national banks may issue short-term promissory notes exempted from the limitations on indebtedness contained in 12 U.S.C. § 82.

As you know, the statute precludes national banks from contracting indebtedness exceeding the amount of their actually paid in capital stock plus 50 percent of unimpaired surplus subject to ten express statutory exceptions, none of which can reasonably be construed to include such promissory notes.

It appears to me that these notes represent short-term indebtedness that should certainly be subject to the statutory limitations on indebtedness. Assuming this is true, the Comptroller's September ruling is contrary to law and beyond his statutory authority.

On the other hand, it might be argued that these securities represent deposits not unlike certificates of deposit which are very much in vogue at the present time. As certificates of deposit, these notes would be subject to reserve requirements, as well as interest rate limitations. However, Comptroller Saxon clearly does not consider these notes deposits subject to these legal requirements.

Under 12 U.S.C. 461, the Board of Governors is empowered to define the term "savings deposits." I am, therefore, requesting that the Board advise the Committee on Banking and Currency of its opinion regarding the deposit status of interest bearing promissory notes. If, of course, these notes, because of their short maturities, might be in the Board's determination demand deposits, then national banks issuing them would be in violation of the prohibition of the payment of interest on demand deposits.

Short-term promissory notes must either represent indebtedness subject to the limitations in 12 U.S.C. § 82 or else they are deposits subject to the applicable legal requirements.

I will appreciate the Board's prompt attention to this very serious matter.

Sincerely,

WRIGHT PATMAN, *Chairman.*

BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM,
Washington, December 15, 1965.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of November 24 with respect to short-term promissory notes issued by national banks. The occasion for your concern is the 1965 ruling of the Comptroller of the Currency that such notes issued by national banks are not subject to the statutory limitation on the extent to which a national bank may "at any time be indebted, or in any way liable". Revised Statutes, section 5202; 12 U.S.C. 82. As you point out, another ruling of the Comptroller, published in 1964, is to the effect that issuance of "promissory notes of any maturity" by national banks does not give rise to deposits in such banks and that provisions of the Federal Reserve Act relating to reserve requirements and limitations on interest rates do not apply to such promissory note transactions.

For historical reasons and because of changes in banking practices, it has been difficult to develop acceptable criteria that would draw a definite and workable distinction, in all situations, between loans and borrowings on the one hand and deposits on the other. However, it seems clear to the Board of Governors, as it does to you, that promissory note transactions must fall within one category or the other—that is, they necessarily give rise either to *indebtedness* of the bank that is subject to R.S. 5202 or to *deposits* that are subject to reserve requirements and legal limitations on interest rates.

In his 1964 ruling, the Comptroller stated that "The proceeds from the sale of such notes do not constitute deposits. . . ." No reason was given for this view, but the ruling did indicate that "Such borrowings are . . . limited by 12 U.S.C. 82." In changing his ruling on the latter point in the September 1965 *National Banking Review*, the Comptroller stated only that "unsubordinated promissory notes of comparatively short term . . . are issued in the ordinary course of banking business as a means of obtaining funds to be used in making loans and the performance of other banking functions . . . ." It is difficult for the Board to see how this statement can serve as a basis for the Comptroller's conclusion that the statutory limitations on national banks' indebtedness are inapplicable to these obligations of national banks.

When the practice of issuing unsecured promissory notes in the ordinary course of business developed in 1964, the Board held that "since such notes constitute borrowings, they are not subject, under present law and regulation, to the interest

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rate limitations or reserve requirements prescribed for deposits by the Board." 1964 *Federal Reserve Bulletin* 1137; 12 C.F.R. 217.138. Developments since that time have given rise to the question whether it would be advisable to amend Federal Reserve Regulations D and Q to provide that the reserve requirements and interest rate limitations prescribed in those regulations, and the statutory prohibition on the payment of interest on demand deposits, would apply to promissory notes of the kinds that are issued by national banks and member State banks in the ordinary course of their business.

The recent ruling by the Comptroller, to which you refer, has made this problem more complicated (as well as more pressing), but the Board hopes that the supervisory agencies may be able to work out a satisfactory solution in the near future.

Sincerely yours,

WM. McC. MARTIN, JR.

[Federal Reserve press release, Jan. 20, 1966]

The Board of Governors today announced proposed amendments to its Regulation D, relating to reserve requirements of member banks, and its Regulation Q. relating to the payment of interest on deposits by member banks. The amendments would in effect define "deposits" for purposes of those regulations as including promissory notes and other forms of indebtedness of member banks with certain exceptions.

In general, the exceptions would exclude from coverage (1) borrowings from Federal Reserve Banks, (2) borrowings from other banks, including so-called "Federal funds transactions," (3) borrowings in the form of transfers of United States obligations under repurchase agreements, and (4) borrowings with maturities of more than two years that are subordinated to claims of depositors and general creditors.

The proposed amendments have been prompted by the development over the past year of the practice among some banks of issuing short-term promissory notes to corporate customers and others in order to obtain loanable funds. This practice has tended to lessen the effectiveness of provisions of the Federal Reserve Act that prohibit the payment of interest on demand deposits, limit the rate of interest payable on time deposits, and require reserves against deposits.

The proposed amendments would apply to any indebtedness within their coverage that is incurred after today (January 20, 1966) that is outstanding after the effective date.

Comments on the proposed amendments should be submitted by February 25, 1966. The amendments would not be made effective until approximately 60 days after their adoption by the Board.

The text of the notice regarding the proposed amendments, as it has been sent to the Federal Register, is attached hereto. The notice includes illustrative examples of the manner in which the amendments would affect particular types of transactions.

FEDERAL RESERVE SYSTEM

[12 CFR Parts 204, 217]

[Regs. D, Q]

RESERVES OF MEMBER BANKS; PAYMENT OF INTEREST ON DEPOSITS

Notice of proposed rule making

The Board of Governors is considering amending § 204.1 of Regulation D ("Reserves of Member Banks") and § 217.1 of Regulation Q ("Payment of Interest on Deposits") by inserting at the beginning of each the following new paragraph:

"(a) *Deposit.*—The term 'deposit' means any indebtedness of a member bank that arises out of a transaction in the ordinary course of its business with respect to either funds received or credit extended by the bank, except (1) indebtedness due to a Federal Reserve Bank, (2) indebtedness due to another bank for its own account that is not reflected on books or reports of the debtor as a deposit or of the creditor as a bank balance, (3) indebtedness arising from a transfer of direct obligations of the United States that the bank is obligated to repurchase, and (4) indebtedness subordinated to the claims of depositors and general

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creditors that has an original maturity of more than two years; *Provided, however*, That this paragraph shall not affect the status, for purposes of this Part, of any indebtedness incurred prior to January 20, 1966."

The present paragraphs (a), (b), (c), (d), (e), (f), (g), (h), and (i) of § 204.1 would be redesignated as paragraphs (b), (c), (d), (e), (f), (g), (h), (i), and (j), respectively. The present paragraphs (a), (b), (c), (d), and (e) of § 217.1 would be redesignated as paragraphs (b), (c), (d), (e), and (f), respectively.

If adopted by the Board, it is contemplated that the amendments would be made effective approximately 60 days after the date of their adoption. The amendments would apply not only to any indebtedness within their coverage incurred after the effective date but also to any such indebtedness outstanding on the effective date that was incurred after January 20, 1966.

During the past year, a number of banks have issued promissory notes as a means of obtaining additional funds. It is now apparent that this practice results in avoidance of laws and regulations governing payment of interest on deposits and maintenance of reserves against deposits.

The proposed amendments to Regulations Q and D are designed to prevent evasions of those laws and regulations and are based upon the premise that, with few exceptions, indebtedness of member banks must be considered and treated as deposits subject to Regulations Q and D in order to effectuate Congressional directives and policies, as expressed in section 19 of the Federal Reserve Act.

The amendments are intended principally to bring promissory notes within the definition of deposits. However, the Board would be prepared to adopt similar amendments with respect to other forms of indebtedness that were being used as a means of avoiding laws or regulations relating to payment of interest on deposits and maintenance by member banks of reserves against deposits.

The following are illustrations of the effects of the presently proposed definition of deposits, from the standpoint of rules governing payment of interest on deposits:

(1) In consideration of the receipt of funds, a member bank issues its promissory note (either negotiable or nonnegotiable) to mature in six months. The bank's liability would be a deposit. Consequently, the rate of interest on the note could not lawfully exceed that permitted on a certificate of deposit.

(2) A member bank issues its note payable on demand or within less than 30 days, either negotiable or nonnegotiable. The bank's liability would constitute a demand deposit, and it could not lawfully pay any interest thereon.

(3) A member bank purchases stationery and office supplies on credit. Such indebtedness would not arise from "funds received or credit extended by the bank", and consequently it would not be a deposit.

(4) A member bank borrows funds on its note, secured by a mortgage on the bank premises, and uses the proceeds to pay for renovation. Although this indebtedness would arise from "funds received" by the bank, the transaction would not be "in the ordinary course of its business", and therefore the indebtedness would not constitute a deposit.

(5) A member bank lends funds to a customer and credits the proceeds to his account. The amount so credited would, as heretofore, be a deposit.

(6) A member bank receives funds, in the ordinary course of its business, from a correspondent bank—whether member or nonmember, domestic or foreign. Consistent with traditional practice and understanding of the parties, the liability of the recipient bank would be a deposit. The proposed definition of "deposit", however, would except from its coverage an interbank indebtedness that is entered and reported by both banks as a loan transaction. A loan of what are commonly termed "Federal funds" is an example of an indebtedness that would fall within such exception.

(7) A member bank issues debentures or notes to provide additional "capital" funds. By contract, the claim of the security holders against the assets of the bank is subordinated to the claims of depositors and all other creditors. Such notes are excepted from the definition of deposit if they have an original maturity of more than two years.

This notice is published pursuant to section 4 of the Administrative Procedure Act and section 1(b) of the Rules of Procedure of the Board of Governors of the Federal Reserve System (12 CFR 262.1(b)).

To aid in the consideration of this matter by the Board, interested persons are invited to submit relevant data, views, or arguments. Any such material should be submitted in writing to the Secretary, Board of Governors of the Fed-

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eral Reserve System, Washington, D.C., 20551, to be received not later than February 25, 1966.

Dated at Washington, D.C., this 20th day of January, 1966.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
(s) Merritt Sherman,
MERRITT SHERMAN, *Secretary.*

(Press release of the New York State Banking Department concerning the illegality of issuance of negotiable promissory notes by national banks in New York State.)

STATE BANKING SUPERINTENDENT CAUTIONS CORPORATE CUSTOMERS ON INVESTMENTS IN NEGOTIABLE NOTES ISSUED BY NATIONAL BANKS IN NEW YORK STATE

Superintendent Wille today issued the following statement with respect to investments in negotiable promissory notes which may be issued by national banks in New York State:

"I have read with interest the recent ruling of the Comptroller of the Currency that national banks in New York State may issue unsecured promissory notes in negotiable form without regard to the prohibitions contained in Section 298 of the New York Penal Law.

The Comptroller bases his conclusion on two propositions: first, that the only statutory provisions applicable to the issuance of such notes by national banks are contained in Federal law, and second, that Section 298 is not, in any event, applicable to national banks since it refers only to banking corporations authorized to carry on the business of banking under the laws of the State of New York.

In my judgment, neither proposition can be regarded as free from doubt. The United States Supreme Court has yet to resolve the question of whether a State may prohibit the issuance of notes by a national bank through a penal law provision which applies uniformly to all banks in the State. Furthermore, as to the intended applicability of Section 298 to national banks in this State, I would point out that such banks are authorized to carry on significant portions of their banking business by specific provisions of New York law.

Corporate treasurers considering an investment in the unsecured notes of a bank located in New York State should be aware that the State's highest court has declared notes in negotiable form, issued in violation of the language of Section 298, to be void and unenforceable.

The New York State Banking Department continues to believe that legislative clarification of the right to issue unsecured promissory notes in negotiable form is desirable. To this end, the Department will sponsor legislation in 1966, as it did in 1965, to repeal Section 298 of the New York Penal Law."

NEW YORK STATE

Section 298. Misconduct by banks and bankers

Any bank corporation or private banker authorized to carry on the business of banking under the laws of this state who:

1. receives, pays out, gives or offers in payment as money to circulate, or who attempts to circulate as money, any bill, note or other evidence of debt issued or purporting to have been issued to any corporation or individual, situated or residing without this state, and which bill, note or other evidence of debt, upon any part thereof, purports to be payable or redeemable at any place or by any corporation or individual within this state; or

2. issues, utters or circulates, as money, or in any way, directly or indirectly, aids or assists in the issuance, uttering or circulating as money within this state, of any bank bill, note or other evidence of debt in the similitude of a bank note issued or purporting to have been issued by any corporation or individual situated or residing without this state; or procures or receives in any manner whatever, any such bank bill, note or other evidence of debt with intent to issue, utter or circulate, or with intent to aid in issuing, uttering or circulating the same as money within this state; or

3. directly or indirectly lends or pays out for paper discounted or purchased any bank bill, note or other evidence of debt, which is not received

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at par by such corporation or banker for debts due such corporation or banker; or

4. issues or puts in circulation any bank bill or note of any such corporation or banker, unless the same shall be made payable on demand and without interest, except bills of exchange on foreign countries or places beyond the limit of jurisdiction of the United States, and accepts certificates of deposit payable on presentation, with or without interest, to bearer or to the order to a person named therein, or certificates of deposit payable with or without interest, to bearer or to the order of a person named therein showing the amount of the deposit, the time of issue and the date when due; but certificates shall not be issued except as representing money as actually on deposit,

is guilty of a misdemeanor.

Nothing in this section contained shall be construed to prohibit any such corporation or banker from receiving and paying out such foreign bank bills as they shall receive at par in the ordinary course of their business, or to prohibit such corporation or banker from receiving foreign notes from their dealers and customers in the regular and usual course of their business, at a rate of discount not exceeding that which is or shall be at the time fixed by law, for the redemption of the bills of the banks of this state and their agencies, or from obtaining from the corporations, associations, or individuals by which such foreign notes are made, the payment or redemption thereof.

(Correspondence concerning the application of Federal securities law to misleading bank advertisements of "savings bonds" (certificates of deposit).)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D.C., January 26, 1966.

Hon. MANUEL F. COHEN,
Chairman, Securities and Exchange Commission,
Washington, D.C.

DEAR CHAIRMAN COHEN: This is with further reference to our previous correspondence concerning misleading newspaper advertisements by commercial banks of so-called "savings bonds". As the Commission has previously acknowledged, such savings bonds—in reality, certificates of deposit (CD's)—are securities within the meaning of the Securities Act of 1933, fully subject to the anti-fraud provisions thereof.

Your Division of Corporate Finance informed me that a specimen of bank advertising of CD's which I had furnished the Commission contained objectionable and misleading language. While probably not serious enough to warrant criminal prosecution under the Securities Act, you did state in your last communication to me, dated October 18, 1965, that you would expect to be in communication with the appropriate Federal bank regulatory agencies in connection with this type of advertising should there be indications that its use is becoming widespread.

Unfortunately, I am afraid this is the case, due in no small part to the most recent restrictive action by the Federal Reserve System on the supply of bank credit. Banks have necessarily sought to increase their time deposits in order to satisfy the legitimate needs of their customers, frequently at the expense of other banks as well as thrift institutions.

While I agree that our private banking system should encourage healthy competition, I must express my strenuous objections to any type of advertising which is capable or likely to mislead the average citizen. I should also mention that up to now the Federal banking agencies have shown no interest in policing bank advertising. Nor is bank advertising subject to regulation by the Federal Trade Commission.

Enclosed are advertisements recently appearing in newspapers in New York City, Washington, D.C., and Atlanta, Georgia, which, according to your previous communications, raise serious questions under the securities laws. I refer particularly to the practice of advertising these "savings bonds" in various "series" such as "discount series", "growth series", and "income series". You will note that two of the enclosed advertisements utilize this method of presentation which I would characterize as nothing more than a misleading gimmick. The third

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advertisement guarantees a "25.1% profit" on a five-year "savings bond" which you have previously indicated as objectionable.

I am not suggesting that these banks are guilty of criminal fraud under the Securities Act of 1933 nor of any willful intent to deceive. However, there is little question that these advertisements are seriously misleading and that they are becoming more and more prevalent as our commercial banks are finding themselves deprived of adequate reserves. I, therefore, earnestly request that you communicate with the banking agencies in a mutual effort to eliminate such questionable and unethical advertising practices which do no credit to the banking industry and which are certainly not in the public interest.

Sincerely,

WRIGHT PATMAN, *Chairman.*

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., May 3, 1966.

Hon. WRIGHT PATMAN,
Chairman, Committee on Banking and Currency,
House of Representatives, Washington, D.C.

DEAR MR. PATMAN: I refer to your letter of January 26, 1966, concerning bank advertising of certificates of deposit.

Members of my staff have met with staff members of the Federal Deposit Insurance Corporation, Federal Reserve Board and the Comptroller of the Currency, in an effort to reach some understanding concerning the types of advertisements referred to in your letter. At the conference it was generally agreed that advertisements by banks of their certificates of deposit should not feature percentage figures of profits which represent a cumulation of interest over more than a year. The banking agencies represented at the conference that they deal with such matters on an individual basis. Other possible disclosure questions were also discussed.

In order to provide the federal banking agencies with opportunity to take whatever action might be appropriate with regard to such advertising, the Commission will continue to refer those advertisements which come to its attention to the federal banking agencies, and will continue to maintain liaison with them.

Sincerely,

MANUEL F. COHEN, *Chairman.*

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N.Y., May 10, 1966.

Hon. WILLIAM MCCHESNEY MARTIN, Jr.,
Chairman, Board of Governors of the Federal Reserve System,
Federal Reserve Building, Washington, D.C.

DEAR CHAIRMAN MARTIN: In line with our practice of keeping the Board of Governors informed on current savings bank developments in this period of great financial change and uncertainty, I am enclosing an industry bulletin presenting preliminary data on the April deposit experience of the savings bank industry. As you know, reports appearing in the national press and elsewhere in recent weeks have indicated, on the basis of partial information, that mutual savings banks sustained heavy savings outflows in April. The attached bulletin, presenting comprehensive April industry deposit figures for the first time, generally confirms these reports.

As indicated in the bulletin, mutual savings banks experienced an estimated $390 million net reduction in regular deposits in April, the largest monthly deposit loss on record. While especially severe in New York City, deposit reductions were widespread in other areas as well.

Seasonal influences, particularly withdrawals for federal income tax payments, played some part in the April deposit decline. And slackened deposit growth at savings banks has, of course, been typical of periods of monetary restraint and high and rising interest rates on competing investment media. An additional factor may have been a reduced rate of overall personal savings relative to income, continuing the trend evident in the first quarter of 1966.

However, the magnitude of the deposit reduction in April 1966 was far in excess of previous seasonal outflows, as well as outflows occurring in earlier periods of financial market stringency. The $390 million deposit loss compares with April reductions of $22 million in 1965 and $109 million in 1960—the previous record reduction for the month. Furthermore, the decline in April 1966 was substantially greater than the $201 million outflow experienced in October 1959, when the "Magic Fives" attracted a substantial volume of funds from individual savers.

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All of this indicates that the April deposit experience of mutual savings banks was without precedent. Such data as are now available suggest that other types of thrift institutions also suffered heavy savings withdrawals during the month. Indeed, savings markets have been subject to continuous flux and churning since the beginning of 1966. And as Under Secretary of the Treasury Deming indicated in a speech reported in the press today, aggressive bidding for time deposits "may tend to distort the impact of monetary policy, impairing the stability of particular institutions and even of some sectors of the economy."

Mr. Deming also warned that "when financial pressures diminish, then time deposit rates—particularly those on savings accounts—may prove to have some downside rigidity." In this setting, the recently announced survey of commercial bank time and savings deposit interest rates, which is being conducted jointly by the Federal Deposit Insurance Corporation and the Federal Reserve System, should provide information essential to appraisal of current developments and future prospects in savings markets.

I hope this information on savings bank deposit trends will be helpful to you. We will continue to inform you of major industry developments as further data become available.

Sincerely yours,

GROVER W. ENSLEY,
Executive Vice President.

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N.Y., May 10, 1966.

To: The member bank addressed.
Re Industry Deposit Trends, April 1966.

In April, mutual savings banks experienced an estimated net reduction in regular deposits amounting to $390 million, the largest deposit outflow for any month in the postwar period. This figure is based on reports of 284 institutions from 15 savings bank states, having about three-fourths of the regular deposits of the industry. The data on deposit trends of these reporting banks comparing April 1966 with March 1966 and April 1965 are shown below:

Trends in regular savings deposits of 284 mutual savings banks [1]

[Dollars in millions]

Month	Change during the month [2]	
	Percent	Amount
April 1966	−0.7	−$291
March 1966	.7	254
April 1965	−.1	−18

[1] Regular savings deposits exclude savings in all special purpose accounts, such as Christmas club, vacation, and school.
[2] Includes interest credited.

The estimated $390 million regular deposit reduction in April 1966 exceeded April outflows of $22 million in 1965 and $109 million in 1960—the previous record deposit loss for the month. In October 1959—when the "Magic Fives" attracted a large volume of funds from individuals—savings banks experienced a decline of $201 million in regular deposits.

While the deposit experience of individual savings banks in April 1966 varied considerably among different areas, deposit losses were widespread. In New York state—which accounts for 58 percent of the industry's total resources—the regular deposit reduction amounted to an estimated $300 million. In other states, deposit losses aggregated about $90 million.

Savings and loan associations also sustained a substantial savings outflow in April, according to government and industry sources. No firm figures are yet available, however. With respect to commercial banks, weekly reporting member banks of the Federal Reserve System showed a $1.7 billion reduction in regular passbook savings, although the total time and savings deposits (including savings certificates, negotiable certificates of deposit and other time deposits) rose by $812 million in April.

Sincerely yours,

SAUL B. KLAMAN,
Director of Research.

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IBA FAVORS 4½ PERCENT CEILING ON TIME DEPOSITS

INDEPENDENT BANKERS ASSOCIATION OF AMERICA.

Hon. WRIGHT PATMAN,
Chairman, House Banking and Currency Committee,
Washington, D.C.

Federal Legislative Committee of the Independent Bankers Association, representing more than 6,400 member banks, has been meeting in Washington, yesterday and today, giving priority among pending bills to your H.J. Res. 1148, H.R. 14026, and related bills. The committee attended the public hearing today and listened to the testimony of Chairman Martin and his interrogation by members of your committee.

We are familiar with the draft of the various bills under consideration and respectfully offer the following as expressing the sense of the Independent Bankers Association: We recognize that the thrust of this bill arises from concern for restraining a potential rate war between the mutual thrift associations and the commercial banks. This possible rate competition contains the elements of damage to both and is clearly not in the public interest. Likewise we recognize the potential for interest rate competition with the banking industry, as well as with the thrift institutions. However we are opposed to the imposition of restraints on the commercial banks without comparable and appropriate restraints on the thrift institutions, which action we believe is equitable and fair. We are mindful of the experiences of the banking industry with former increases in the maximum permissible rates, where the permissible rate has rapidly become the floor as well as the ceiling.

In view of this we do not believe a 5-percent rate will accomplish relief in the rate competition between the thrift institutions and the commercial banks. For such purpose it is our belief that the ceiling should not exceed 4½ percent. Our other principal positions include: authorization to increase reserve requirements should be premised upon authorizing appropriate reserve requirements for thrift institutions and other financial intermediaries. Further we believe that a system of graduated reserve requirements by size of bank would be desirable. We are opposed to proposals to require interagency coordination on changes in interest rate limitations. We believe the Federal Reserve Board should be given the power to distinguish between certificates of deposit as money market instruments and time deposits and passbook savings accounts which are in the nature of thrift accounts.

We are opposed to revision of section 14(b) of the Federal Reserve Act to make obligations of the Federal Home Loan Bank and of the FNMA issued a secondary market operation eligible for purchase by the Federal Reserve Board. We believe the purpose of injecting funds into the mortgage market is best accomplished directly through the Treasury Department.

PAT DUBOIS,
President.
REED H. ALBIG,
Chairman of Federal Legislative Committee.

BRADFORD R. COLLINS, REALTOR,
West Springfield, Mass., June 6. 1966.

Hon. EDWARD P. BOLAND,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN BOLAND: May I have this opportunity of communicating with you relative to the hearings now being held by the House Banking and Currency Committee.

I realize you are not a member of this committee, but I felt I should discuss with you the mortgage money situation. As a realtor, I am vitally interested in having a reasonably steady flow of mortgage money in order that home properties sold by my office might be readily financed. Due to the extreme tightness of money I find it very difficult to place home loans with area banks at the present time.

Several bank officials that I have approached recently have expressed regrets at not being able to make new commitments as their supply of mortgage funds has been nearly exhausted. Some of these bankers have indicated that the shifting of money has caused them to curtail their mortgage lending. Much of the

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money, I have learned, has gone to national banks paying higher rates on certificates of deposit than the mortgage banks pay on deposits. Of course the commercial banks are not interested in long-term investments such as home mortgages, with the result it is becoming increasingly more difficult to place my loans. Several builders for whom I sell newly completed homes, are also unable to secure new construction loans.

I fear if the Government does not take immediate steps to stop this type of money flow that the effect on the economy of our area will be most serious. I respectfully urge you to use your position of respect and high regard in which you are held by your fellow Congressmen and do everything possible to cure this very disastrous condition.

You are assured that you have my sincere appreciation for any effort you may make at this time to help those of us in the home building and sales field.

Most sincerely,

BRADFORD R. COLLINS.

LUDLOW SAVINGS BANK,
Ludlow, Mass., June 20, 1966.

Representative EDWARD P. BOLAND,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN BOLAND: We note with concern the mounting inability of prudent savers to complement savings destined, in part or in full, to complement borrowed mortgage loan funds for the purpose of purchasing or constructing a home for themselves.

Having allowed an adequate cushion in fulfilling our legal quota and relying on a well-determined pattern of loan amortization, our present operation is not in immediate danger of violating statutes.

The growth of deposits however has slowed to a rate which makes present loan flotation hazardous.

How a prudent saver visualizing at long last a comfortable home for his family, a universally accepted more of a healthy democracy, at length becomes the victim of a financial tug-of-war between large financial forces is no doubt a source of wonder, not only to him, but to all who know of the condition.

The financial forces effecting the economy today are ponderous and writhing, slow to take form, and slow to dissolve, and the efforts of even many men will in no sense soon blunt the impact of such forces.

We know of your propensity to consider and to possibly take action in situations concerning the welfare of citizens of our country and do hereby humbly petition you to seek ways to alleviate the present financial stringency that prevails in the mortgage loan area at this time.

Sincerely yours,

OTTO A. PETERSON, *President.*

THE NATIONAL SHAWMUT BANK OF BOSTON,
June 9, 1966.

Hon. THOMAS P. O'NEILL, JR.,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN O'NEILL: Two legislative proposals presently before the House Banking and Currency Committee merit your most careful analysis prior to taking any position thereon. I refer to H.R. 14026, a committee-sponsored bill, which would prohibit commercial banks from issuing negotiable certificates of deposit, and H.R. 14422, a bill introduced by Congressman Ottinger, which would prohibit acceptance by any insured bank of any time deposit less than $15,000.

You are well aware, I am sure, of the arguments relating to these proposals so I will no more than briefly summarize the position of Shawmut Bank on these bills as follow:

> First: The bank supervisory agencies, Federal Reserve Board and FDIC, should complete their current interest-rate survey before any legislative action, in committee or otherwise, is taken. Full knowledge of the facts is essential prior to any legislative action.
>
> Second: If emergency measures are deemed necessary, discretionary authority to set maximum interest rates should be given the Federal Reserve Board and the FDIC as best qualified to adopt ceilings within economic conditions prevailing from time to time. Arbitrary maximum rates set

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by law might be justifiable today but unjustifiable tomorrow. Flexibility of action, through bank supervisory agencies, is deemed essential.

Third: Any interest-rate restrictions on commercial banks through the Federal Reserve Board and the FDIC should likewise be imposed on savings and loan associations by identical regulations of the FHLBB. Fairness to depositors and stockholders of all banking institutions requires this position.

Your most careful consideration of H.R. 14026 and H.R. 14422 is sincerely urged as the issues involved are of paramount importance to the economy of the country in this period of crisis.

Yours very sincerely,

LAWRENCE H. MARTIN, *President.*

ALAMEDA, CALIF.,
June 20, 1966.

Hon. GEORGE P. MILLER,
House of Representatives, Washington, D.C.

DEAR HONORABLE MILLER: The board of directors of the Alameda First National Bank, Alameda, Calif., patently object to the discriminatory nature of H.R. 14026 bank time deposit interest rate limitation. We respectfully urge yon to intercede on our behalf in opposition to this bill.

FRANZ S. COLLINSHONN, DONALD L. DULLUM, A. H. MOFFITT, JR., ELLIOT S. PETERSON, RUSSELL A. SPILLMAN, WESLEY F. SUMAN, Alameda First National Bank, Alameda, Calif.

[From the New York Times, June 15, 1966]

THE SAVINGS WAR

In intervening in the interest rate war between banks and other savings institutions, the Treasury is supporting a proposal to ban commercial banks from paying more than 5 percent on deposits of up to $100,000 and is reportedly considering legislation to keep them from paying more than 4½ percent on small accounts.

Such restrictions would blunt one of the competitive weapons employed by the commercial banks, but it will not halt the bitter and harmful battle for the savings dollar between the banks on the one hand and the mutual savings banks and savings and loan institutions on the other.

The thrift institutions lost over $1.1 billion in deposits in April, losses that have meant a shortage of funds available for investment in mortgages. There could be a real scarcity of mortgage money as well as a serious liquidity squeeze on individual institutions if fresh withdrawals took place at the end of the current quarter.

Representative Wright Patman, of Texas, has proposed restricting the powers of commercial banks as a means of equalizing competition. James L. Robertson, vice chairman of the Federal Reserve Board, has suggested an expansion in the powers of the savings institutions so that they can wage more effective war against the banks, a proposal that would have the effect of turning savings institutions into commercial banks. The Treasury, going along with Mr. Patman, wants to preserve the differences between the banks and the thrift institutions, which traditionally channel funds from small savers into the housing market.

These differences are worth preserving. But the restoration of a better competitive balance essential to protect the position of thrift institutions does not lie in measures to penalize commercial banks or the public. Whatever the Treasury does about commercial banks, the position of the thrift institutions will not be restored so long as demand for credit continues to grow and the monetary authorities are forced to ration the supply.

The administration's own policies have worsened the situation. It's overreliance on credit policy has made money scare and expensive. Its new practice of selling participations in Government-owned loans—a move designed to make its budget deficit look smaller—at rich yields of up to 5.75 percent is hitting at both commercial banks and thrift institutions. And the high interest rates now prevailing on other Federal and local government obligations and on other securities available to the public may well bring further erosion in the position of the savings institutions even if the power of the banks were to be curbed.

So unless demand lessens voluntarily or the administration takes action to restrain it, the battle for savings and the threat of a liquidity shortage in savings and loan institutions will not fade away.

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NEW YORK CLEARING HOUSE,
New York, N.Y., June 6, 1966.

Re H.R. 14026, H.R. 14422, House Joint Resolution 1148 and related proposals.

HON. WRIGHT PATMAN,
Chairman, Banking and Currency Committee, U.S. House of Representatives, Washington, D.C.

DEAR MR. PATMAN: Various measures have been designed for the purpose of relieving the temporary strains on certain of the savings and loan associations and savings banks as a result of the present pressures on the credit market and encouraging a greater flow of funds into the mortgage market. These measures would: (1) forbid insured banks to make or issue any negotiable certificate of deposit, note, debenture or other negotiable obligation which yields any return; or (2) forbid any insured bank to accept any time deposit in an amount less than $15,000; or (3) increase reserve requirements on time accounts; or (4) forbid for two years insured banks to pay interest on any time deposit, savings deposit or borrowing at a rate in excess of 4½% or such other rate as may be approved by the Board of Governors of the Federal Reserve System with the approval of the President.

We submit that the effect of these proposals if any of them should be enacted would be seriously harmful to our economy and even self defeating in terms of easing the pressures on the mortgage market and on weaker borrowers generally.

Other more limited proposals have been made such as the suggestion of Secretary Fowler to place temporarily a lower interest ceiling on the first $10,000 of a time deposit than on the balance, if any, possibly combining this with varying interest ceilings dependent on the maturity of the deposit. These proposals, contemplating interest ceilings more in line with prevailing market rates, and lodging discretionary authority in the Federal Reserve, more fully recognize the inherent limitation on actions of this kind to meet the problems of concern to your Committee without creating still more serious problems for the wide variety of other borrowers dependent upon commercial bank financing. While it must be recognized that these proposals would also entail an undesirable inhibition on flexible and competitive credit markets, of the various proposals made this would be the least onerous.

We call your attention to the fact that the established powers of the Federal National Mortgage Association to provide a secondary market for insured or guaranteed mortgages and in its special assistance programs, the authority of the Federal Home Loan Bank System to lend to member thrift institutions up to 50% of their savings capital in time of need, the ability of the Home Loan Banks to call upon the Treasury for funds as well as to borrow in the open market, and deposit and share account insurance itself, are designed to meet precisely the kind of strains of concern to your Committee. Intelligent and forceful use of these instruments, when and as needed, represent in our judgment the best possible assurance that the transitional difficulties posed by recent developments in the credit markets can be successfully resolved.

As pointed out in the Report of the Inter-Agency Committee on Financial Institutions appointed by President Kennedy in 1962, commercial banks are the most widely dispersed geographically of all lending institutions. They are necessarily in close contact with all elements in a community. A commercial bank is sometimes the only lending institution conveniently available to local borrowers and is often the only source of credit to finance current business operations. Bank credit supports the growth of every area of the economy—agriculture and food processing, industrial modernization and expansion, trade and distribution, purchases of consumer durables, exports (important to the balance of payments program), state and municipal construction, hospitals and other community services and not least, home builders and home buyers. In fact, commercial banks have, since 1961, added $20 billion to their holdings of mortgages.

This diversified lending business has necessarily required an ability to attract funds from a wide variety of sources, including both individuals and businesses, in the form of interest bearing deposits and capital notes as well as demand deposits. The Committee on Financial Institutions concluded, and this conclusion is widely shared by other observers, that this diversified lending and borrowing activity was appropriate. It is in fact critically important to the financial support of an expanding American economy.

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The fact is that demand deposits have grown only slowly in the past twenty years, less than a third as fast as economic activity generally. Among New York City banks net demand deposits are actually lower than two decades ago. Consequently, if commercial banks are to meet the needs not only of short-term commercial borrowers, but also other sectors of the economy, they must be able to compete for interest bearing funds and to compete for them effectively. The active mortgage lending by commercial banks in recent years has been made possible by their ability to do this.

The more than $17 billion of funds now estimated to be in the form of negotiable certificates of deposit has been particularly important in terms of marshalling the resources necessary to finance the unparalleled period of business expansion and prosperity of the past five years. These funds are typically obtained in sizable blocks from large corporations, state and local governments, foreigners, and other large investors. These investors are highly sensitive to interest rate differentials in placing their funds, and are subject to the need for a high degree of liquidity in their portfolios as well. The negotiable certificate of deposit, by permitting banks to compete effectively for funds from these sources, has made such funds available for use by the broad spectrum of borrowers with access to banks, including local businesses, consumers, home buyers, and state and local governments. The result contributed immensely to the national objective of making ample credit available in all sections of the country to finance expansion.

Had the negotiable certificate of deposit not been available, banks could not have met the variety of credit demands placed upon them throughout the expansion. Nor would these funds, to any significant extent, have flowed to other thrift institutions, constrained by law, by experience, and by tradition, from competing for this kind of large scale interest-sensitive money. For instance, the $17 billion of funds now in negotiable certificates would surely have been channeled directly into the open market, and sought an outlet in the relatively few forms of pre-existing high-grade short-term paper, such as government securities, bankers' acceptances, and the obligations of a relative handful of large and strong corporations able to borrow directly in the money market in their own names. A not inconsiderable portion might well have been attracted to the Eurodollar market and have thus aggravated our balance of payments problem and diverted credit from domestic borrowers. As a consequence, strong domestic and foreign borrowers would have been favored at the expense of medium-sized and smaller domestic businesses, homeowners, consumers and other borrowers looking to banks as a relatively economical and readily available source of funds. The adverse consequences for a strong and well-balanced business expansion are plain.

In that connection, it should be noted that during the period from early 1961 to 1965, the period of intense growth in the use of negotiable certificates of deposit, and of substantial growth in other forms of commercial bank time deposits, both savings and loan associations and mutual savings banks experienced rapid growth in their savings accounts. Savings accounts at those institutions rose by $64 billion over that period, $26 billion more than during the previous five years when negotiable certificates were very limited and Regulation Q ceilings constrained commercial bank efforts to obtain time money. This $64 billion figure approaches the aggregate increase of approximately $73 billion in time money of all types at commercial banks during the same period. Plainly, commercial bank competition for the liquid funds of corporations or other large investors, or for time money generally, is consistent with rapid growth of other thrift institutions.

The weekly reporting commercial banks around the country have lost $2.2 billion of savings accounts since the end of 1965. Growth in savings certificates and domestic non-negotiable certificates of deposit bearing a higher rate of interest has more than offset those drains for the period as a whole, but the increase in the aggregate was substantially less than a year ago. Thus tight money and higher interest rates create difficulties for all thrift institutions, and this common problem cannot be met satisfactorily by simply limiting the capacity of one institution or another to compete.. This common problem is illustrated by the attractive rates on United States Government Agency issues which have been sold recently at rates of 5½ or more in competition with other market instruments such as certificates of deposit.

We have the following comments with respect to the specific pending proposals:

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1. PROHIBITION OF THE ISSUE OF CERTIFICATES OF DEPOSIT, NOTES, DEBENTURES, ETC.

To outlaw the negotiable certificate of deposit would simply make it impossible for banks in the future to redistribute the large blocks of liquid funds of sizable investors to widely dispersed borrowers of all types in all parts of the country. More immediately, the impact would be to collapse, in the space of a few weeks, a significant part of the structure of bank deposits and credit, with incalculable but clearly severe disruptive effects on the entire credit market and on the economy itself. Faced with the certainty of huge deposit losses as existing negotiable certificates mature, banks would have no choice but the drastic restriction of credit extensions and the liquidation of existing marketable assets. With holdings of U.S. Government securities already close to working minimums, this liquidation would inevitably fall in large part on the already tight markets for mortgages and state and local government securities.

Presumably the funds now in negotiable certificates might eventually find their way back into the credit markets through other channels. Some limited portion might be attracted by commercial banks in the form of non-negotiable time deposits, although this would imply an ability by banks to pay even higher rates to compensate for the loss of negotiability. However, since these funds are primarily short-term liquidity reserves of larger businesses and institutions, the great bulk would seek other outlets in the open market, and thus would no longer be available for relending to the wide diversity of borrowers from commercial banks. Nor would they significantly relieve the pressures on the mortgage market or other thrift institutions constrained by law and practice from competing for these funds. Instead, the money and credit markets would be subjected to gross distortions. Small borrowers of all varieties and all but the strongest of the larger borrowers would face a drastic contraction in their sources of funds, with accompanying severe dislocations.

The effect of H.R. 14026 would extend even beyond this area of short-term negotiable CD's, for it would, in prohibiting negotiable notes and debentures, cut off from commercial banks an increasingly important source of capital for the protection of depositors.

2. PROHIBITION OF THE ACCEPTANCE OF TIME DEPOSITS OF LESS THAN $15,000

One of the alternative proposals would prohibit banks from accepting time deposits below some specified size limit in an effort to reach the area of competition between commercial banks and other thrift institutions. The practical effect of such a prohibition would, of course, be to discriminate directly against individuals of limited means and small businesses with relatively small amounts of funds to invest. Those depositors, to obtain higher yielding investment media easily available to larger depositors, would instead have strong incentives to purchase marketable securities such as corporate or municipal bonds, less suited in many instances to their investment objectives. There could be no assurance that any substantial part of these funds could be attracted to other thrift institutions, particularly funds held by depositors who are "shopping" for the highest available rate.

Apart from the discrimination implied in terms of the size of the deposits, this proposal conflicts directly with the basic concept of commercial banks as diversified financial intermediaries. It would strike particularly hard at those commercial banks outside the major financial centers which have served their local communities successfully through cultivating substantial savings funds from individuals with moderate resources. Some of these banks have long attracted these funds by time deposit certificates rather than by passbook savings accounts. This proposal would arbitrarily shut these banks off from a major source of funds.

The impact, in terms of constricted lending ability, would be felt by borrowing customers in the local communities served by those banks, and the impact would be proportionately larger in the case of banks outside the major financial centers.

3. INCREASE RESERVE REQUIREMENTS FOR TIME ACCOUNTS

It has also been proposed that competition for savings among financial institutions might be lessened, to the benefit of savings and loan associations and savings banks, by increasing the reserve requirements imposed on all or part of the time deposits held by commercial banks.

It should be recognized that the present situation already discriminates against commercial banks because the requirement of a non-earning reserve against their

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deposits results in a cost of money to them which is higher than it is for others who issue obligations which compete in the same markets for funds.

Objective studies of this situation, such as those of the Commission on Money and Credit and the President's Committee on Financial Institutions have recommended that this discrimination be completely removed. It would certainly be both unsound and inequitable to increase it.

No benefit, to either the home building industry or to other thrift institutions, in either the short-run or the long-run, could possibly flow from this action.

4. IMPOSITION OF A 4½ PERCENT INTEREST CEILING ON TIME DEPOSITS SUBJECT TO INCREASE WITH THE APPROVAL OF THE FEDERAL RESERVE BOARD AND THE PRESIDENT

The practical effect of imposition of a lower interest ceiling at this time than is consistent with the present supply and demand situation in the credit market would be substantially the same as an outright prohibition against commercial banks accepting time deposits. True, H.J. Res. 1148 would permit the 4½% ceiling to be raised, but, in the face of a Congressional mandate for the 4½% rate, the Board of Governors and the President can be expected to hesitate for a long time before bringing the rate up to the levels set by competing outlets for investment.

In the interim, the large domestic and foreign suppliers of funds to the banking system would seek alternate sources for liquid investments, including the Eurodollar market and short term corporate and municipal bonds. As indicated above, funds of this kind would not flow in any quantity, if at all, to the other thrift institutions and in a short time there would be a very substantial net outflow of funds hitherto available for bank lending to all sectors of the community. The results would be to a lesser degree and, presumably for a shorter time, comparable to those which could be expected if negotiable certificates of deposit were outlawed entirely.

Attempts to validate lower rate levels through a massive injection of new money by the Federal Reserve into the banking system, if successful at all, could only accelerate and magnify the inflationary process that current policies seek to restrain.

5. LOWER INTEREST CEILINGS ON THE FIRST $10,000 OF A TIME DEPOSIT

The proposal of the Secretary of the Treasury, providing that for a limited period the Federal Reserve be given the power to discriminate by administratively setting a lower ceiling on rates paid on time deposits of $10,000 or less (including the first $10,000 of any larger deposit), more fully recognizes the complexities of the market and institutional setting and the sharply adverse repercussions of a flat prohibition. It clearly does not resolve the problem of discrimination against the smaller depositor, nor would its impact be evenly distributed among competing commercial banks or thrift institutions. As the Secretary himself pointed out, it would represent a departure from the principle that the economy is best served by full and active competition among financial institutions as well as non-financial businesses.

6. CONCLUSION

In making these comments, we do not in any way want to appear to underestimate the problem faced by thrift institutions and the apparent pressures on the mortgage market that have been a source of concern to your Committee. In particular, we fully recognize that a continuing flow of mortgage credit is essential to balanced economic growth and to the social objectives of this country. We are acutely aware of the damage that could ensue for financial institutions generally should the public become concerned over the safety and liquidity of funds entrusted to any important segment of the savings and thrift industry. We are confident, however, that the Administration and the agencies involved together have effective means for alleviating transitional strains in these areas.

If, however, legislation is felt necessary nearly all of the Clearing House banks believe that Secretary Fowler's suggestion to impose a lower interest ceiling on the first $10,000 of a time deposit for a limited period would be the most useful in terms of accomplishing the purposes desired with the least disturbance to other sectors of the economy.

Very truly yours,

GEORGE CHAMPION, *President.*

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[From the Federal Reserve Bulletin, April 1963, pp. 458-468]

Negotiable Time Certificates of Deposit

NEGOTIABLE TIME CERTIFICATES of deposit have become a major money market instrument. A special survey by the Federal Reserve of 410 member banks indicates that such certificates outstanding at these banks had reached $6.2 billion by December 5, 1962. This compares with just over $1 billion at the end of 1960 and $3.2 billion at the end of 1961. Of the banks covered by the survey, only 44 per cent were issuing certificates in December 1960, but by late 1962, 66 per cent were. The volume of certificates outstanding near the end of 1962 compares with $6.0 billion of commercial and finance company paper and only $2.7 billion of bankers' acceptances.

Time certificates of deposit (CD's) serve as a means for an individual bank to attract funds that might migrate elsewhere in search of higher investment returns. For example, when a corporate depositor draws down demand deposits to buy U.S. Government securities, the deposits move to the bank at which the seller of the bills has his account. And this is often not the bank where the buyer has held his deposit. If individual banks can offer negotiable CD's to potential investors, they can counteract some of this kind of deposit outflow.

Time certificates of deposit, issued for many years on a local and regional scale, are essentially evidence that a depositor will leave his funds for a specified length of time in return for a specific rate of interest. As evidence of such a claim, many of these certificates have always been legally negotiable. But in the last 2 years they have become highly marketable—that is, easily sold to third parties before maturity—as a result of two related events in early 1961. At that time several large money market banks in New York City began to offer CD's in readily marketable form to their corporate depositors. And one securities firm announced that it stood ready to buy and sell CD's in open trading. The practice was soon taken up by other banks and other dealers. By offering certificates with this high degree of marketability, banks have been able to attract large amounts of funds.

Not all CD's are readily marketable despite the establishment of a flourishing secondary market. Many are issued by banks that are not well known outside their own localities. Others have been issued in denominations that are too small to attract the large-scale investors that are active in the secondary market. And in any case, many

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NOTE.—This survey was planned by a System Committee on Negotiable Time Certificates of Deposit, with George Garvy, Economic Adviser of the Federal Reserve Bank of New York, as Chairman. The survey was carried out by members of the staff of the Board of Governors of the Federal Reserve System and the Federal Reserve Banks. The 410 banks covered by the survey included all 351 respondents in the weekly reporting member bank series and selected additional banks in several districts which the Federal Reserve Banks believed might have an appreciable volume of negotiable time certificates of deposit outstanding.

Robert Lindsay, Senior Economist of the research staff of the Federal Reserve Bank of New York and Chairman of a System subcommittee responsible for evaluating the results of the survey, prepared this article. Robert R. Wyand II, Economist in the Board's Banking Section, had responsibility for processing the data and preparing statistical tables, under the supervision of James B. Eckert, Chief.

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holders in practice do not buy with the intention of selling. While the typical denomination in this market is $1 million or more, transactions involving CD's as small as $500,000 are fairly common, and there are occasional trades in denominations of $100,000 or less. As the market continues to broaden, these smaller denominations may become increasingly marketable.

Negotiable CD's proved immediately attractive to corporations and others and quickly found a place alongside Treasury bills and commercial paper as a medium for short-term investment. By the end of 1962, the market for negotiable CD's had become national and had become an important segment of the nation's money market.

The rapid growth of CD's and the increasing participation by the banking community have raised several questions. What kinds of banks have contributed to the sharp increase in outstanding CD's? Who have their customers been? And what are the characteristics of the instrument itself?

ISSUING BANKS

The largest banks—those with total deposits of over $1 billion—experienced the most rapid growth in CD's over the period covered by the survey. At the end of 1960 these banks had accounted for only about 10 per cent of total CD's outstanding, but by the end of 1962 they had issued about 45 per cent of the total. The more pronounced growth at the large banks was also evident in the number of issuing banks in each of the four size groups. It was equally marked when the banks were grouped according to amount of certificates outstanding. (See Table 1 on the following pages.)

By contrast, growth at banks in each of the smaller size groups covered by the survey was slower. Nevertheless, at the time of the survey holdings at these smaller banks were sizable. For example, banks in the two smaller groups—that is, with deposits of $500 million or less—had issued more than a fourth of the total outstandings. Banks with deposits of less than $100 million had only a small part of the volume of CD's outstanding. Most of these were at banks with total deposits of $50 million or more, as few banks below this size were covered by the survey in most districts.

The pronounced growth of certificates at the large banks was partly a result of their having adopted so recently an activity that had long been practiced at many smaller banks. This was an influential decision that helped to create a new market for all CD's, including those of banks that had been issuing them for many years. It led in turn, however, to a sharp increase in the volume of CD's issued by the smaller banks as well. Thus, at the time of the survey, the largest banks still accounted for a smaller percentage of the CD's issued at all reporting banks (44 per cent) than of total deposits of these banks (52 per cent).

The participation of smaller banks is also suggested by the sizes of the certificates issued, relative to the size of the issuing bank. About 72 per cent of the issuing banks had CD's of $500,000 or more, which can usually be traded in the secondary market without great difficulty. And about 90 per cent of the issuing banks had outstanding CD's at least as large as $100,000, a denomination that is sometimes traded. Moreover, about 55 per cent of the banks with some CD's of $500,000 or more outstanding were banks that had issued a total of less than $10 million of such certificates. This pattern suggests a wide distribution of CD's among banks outside the major money market centers, even if many of the smaller

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TABLE 1

VOLUME OF TIME CERTIFICATES AND NUMBER OF ISSUING BANKS

Date and denomination	Total reporting banks	Banks ranked by amount of—[1]						
		Total deposits (millions of dollars)				Total outstanding certificates (millions of dollars)		
		Under 100	100–500	500–1,000	1,000 and over	Under 10	10–50	50 and over
	Amount (millions of dollars)							
Dec. 31, 1960:								
All denominations	1,095	139	366	477	114	306	329	461
Under $100,000	265	61	92	104	8	111	93	60
$100,000–500,000	328	49	118	138	23	107	99	122
$500,000 and over	450	28	156	235	31	85	137	228
Dec. 30, 1961:								
All denominations	3,223	151	690	804	1,578	430	710	2,083
Under $100,000	330	67	127	121	15	134	113	83
$100,000–500,000	614	57	205	234	117	151	193	270
$500,000 and over	2,156	25	354	449	1,329	144	400	1,613
Dec. 5, 1962:								
All denominations	6,181	296	1,400	1,744	2,742	839	1,336	4,005
Under $100,000	597	133	247	167	51	273	183	141
$100,000–500,000	978	94	321	352	211	240	309	429
$500,000 and over	4,606	69	832	1,225	2,480	326	844	3,435
	Number of banks							
Dec. 31, 1960:								
All denominations	182	64	83	25	10	124	38	20
Under $100,000	172	62	81	21	8	117	37	18
$100,000–500,000	144	42	72	21	9	91	35	18
$500,000 and over	95	17	51	18	9	44	33	18
Dec. 30, 1961:								
All denominations	232	72	105	35	20	151	49	32
Under $100,000	205	68	93	30	14	135	44	26
$100,000–500,000	192	51	90	34	17	115	48	29
$500,000 and over	153	21	78	35	19	72	49	32
Dec. 5, 1962:								
All denominations	270	82	128	40	20	182	56	32
Under $100,000	235	79	109	34	13	160	50	25
$100,000–500,000	224	57	110	38	19	138	55	31
$500,000 and over	194	31	103	40	20	106	56	32

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TABLE 1—Continued

VOLUME OF TIME CERTIFICATES AND NUMBER OF ISSUING BANKS

Date and denomination	Total reporting banks	Banks ranked by amount of—[1]						
		Total deposits (millions of dollars)				Total outstanding certificates (millions of dollars)		
		Under 100	100–500	500–1,000	1,000 and over	Under 10	10–50	50 and over
	Percentage distribution of amount							
Dec. 31, 1960:								
All denominations	100.0	12.7	33.4	43.5	10.4	27.9	30.0	42.1
Under $100,000	100.0	23.0	34.7	39.2	3.0	41.9	35.1	22.6
$100,000-500,000	100.0	14.9	36.0	42.1	7.0	32.6	30.2	37.2
$500,000 and over	100.0	6.2	34.7	52.2	6.9	18.9	30.4	50.7
Dec. 30, 1961:								
All denominations	100.0	4.7	21.4	24.9	49.0	13.3	22.0	64.6
Under $100,000	100.0	20.3	38.5	36.7	4.5	40.6	34.2	25.2
$100,000-500,000	100.0	9.3	33.4	38.1	19.9	24.6	31.4	44.0
$500,000 and over	100.0	1.2	16.4	20.8	61.6	6.7	18.6	74.8
Dec. 5, 1962:								
All denominations	100.0	4.8	22.7	28.2	44.4	13.6	21.6	64.8
Under $100,000	100.0	22.3	41.4	28.0	8.5	45.7	30.7	23.6
$100,000-500,000	100.0	9.6	32.8	36.0	21.6	24.5	31.6	43.9
$500,000 and over	100.0	1.5	18.1	26.6	53.8	7.1	18.3	74.6
	Percentage distribution of banks							
Dec. 31, 1960:								
All denominations	100.0	35.2	45.6	13.7	5.5	68.1	20.9	11.0
Under $100,000	100.0	36.0	47.1	12.2	4.7	68.0	21.5	10.5
$100,000-500,000	100.0	29.2	50.0	14.6	6.3	63.2	24.3	12.5
$500,000 and over	100.0	17.9	53.7	18.9	9.5	46.3	34.7	18.9
Dec. 30, 1961:								
All denominations	100.0	31.0	45.3	15.1	8.6	65.1	21.1	13.8
Under $100,000	100.0	33.2	45.4	14.6	6.8	65.9	21.5	12.7
$100,000-500,000	100.0	26.6	46.9	17.7	8.9	59.9	25.0	15.1
$500,000 and over	100.0	13.7	51.0	22.9	12.4	47.1	32.0	20.9
Dec. 5, 1962:								
All denominations	100.0	30.4	47.4	14.8	7.4	67.5	20.7	11.9
Under $100,000	100.0	33.6	46.4	14.5	5.5	68.1	21.3	10.6
$100,000-500,000	100.0	25.4	49.1	17.0	8.5	61.6	24.6	13.8
$500,000 and over	100.0	16.0	53.1	20.6	10.3	54.6	28.9	16.5

[1] Banks issuing CD's were ranked according to their amounts of outstanding certificates in denominations of $100,000 or more. Although outstanding CD's in denominations under $100,000 were *not* included in determining a bank's ranking, these certificates *are* included in the amounts shown in the body of the table. The rankings by deposits and by certificates were as of Dec. 5, 1962.

NOTE.—In this and the following tables only outstanding negotiable time certificates are included. Details may not add to totals because of rounding.

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banks may have issued only a few certificates in these large denominations.

The growth in CD's occurred in all Federal Reserve districts, but the rate of growth differed greatly from one district to another (Table 2). The smallest rate of increase occurred in the Dallas District, where use of CD's was already well developed by 1960. Indeed, member banks in the Dallas area accounted for about a third of all CD's outstanding at the end of 1960. In other districts the expansion started from a smaller base, and in each of these the volume at least doubled over the 2 years. In most of the districts it grew even more.

By December 1962, banks in the New York District had become much the largest issuers of CD's; they accounted for more than one-third of the total outstanding. The Chicago District was second, with less than a sixth of the total.

ORIGINAL PURCHASERS

Businesses were the original purchasers of 69 per cent of the total volume of CD's in denominations of $100,000 and over that were outstanding at the time of the survey (Table 3). The second largest purchasers—but much less important—were State and local governments. Foreign purchases, official and private, were much smaller, and individual purchases smaller yet.

Businesses were especially important as original purchasers at large banks. This was to be expected. Large national corporations, which tend to bank with the big money market banks, have also been among the heaviest investors in Treasury bills and other short-term market instruments. With the emergence of negotiable CD's as an alternative outlet for short-term funds, it is understandable that banks with total deposits of $1 billion or over have issued almost 80 per

TABLE 2

LOCATION OF TIME CERTIFICATES

F. R. District	Number of banks				Amount (millions of dollars)		
	Surveyed on Dec. 5, 1962	Reporting outstandings as of—					
		Dec. 31, 1960	Dec. 30, 1961	Dec. 5, 1962	Dec. 31, 1960	Dec. 30, 1961	Dec. 5, 1962
Boston	33	11	16	23	21	82	159
New York	37	14	26	33	132	1,117	2,217
Philadelphia	16	5	7	9	3	41	133
Cleveland	26	13	16	18	49	253	507
Richmond	21	9	13	14	59	113	137
Atlanta	34	10	13	18	50	103	193
Chicago	61	24	32	39	65	382	940
St. Louis	28	11	12	16	25	54	165
Minneapolis	20	2	4	4	....	30	192
Kansas City	51	22	26	28	64	98	158
Dallas	45	35	36	36	326	405	600
San Francisco	38	26	31	32	301	546	779
Total	410	182	232	270	1,095	3,223	6,181

See Note to Table 1.

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cent of their total CD's outstanding to corporations and other businesses. At smaller banks, the business share was smaller—less than half of the total at banks with deposits of less than $100 million. A similar pattern emerges when banks are grouped by the amount of their outstanding CD's rather than by the amount of their total deposits.

As one moves from larger to smaller banks, business firms as original purchasers give way steadily to State and local governments. At banks with deposits of $1 billion or over these units accounted for less than 6 per cent of the total outstanding. In the smaller banks, however, they were somewhat behind business firms as original purchasers.

The remaining groups combined—foreign, individual, and other—were original purchasers of less than 20 per cent of

TABLE 3

ORIGINAL PURCHASERS OF TIME CERTIFICATES OUTSTANDING ON DECEMBER 5, 1962

Original purchaser	Total reporting banks	Banks ranked by amount of—						
		Total deposits (millions of dollars)				Total outstanding certificates [1] (millions of dollars)		
		Under 100	100–500	500–1,000	1,000 and over	Under 10	10–50	50 and over
	Certificates of $100,000 and over							
Amount (millions of dollars)								
Total	5,584	163	1,153	1,577	2,691	566	1,153	3,864
Original purchaser:								
Businesses	3,851	78	690	963	2,121	309	699	2,842
Individuals	143	11	54	48	30	32	35	76
State and local govt.	867	65	303	350	149	174	321	372
Foreign official [2]	348	....	25	42	283	17	38	294
All other foreign	41	....	7	5	29	3	9	30
Other	335	9	75	169	82	31	52	252
Percentage distribution								
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Original purchaser:								
Businesses	69.0	47.9	59.8	61.1	78.8	54.6	60.6	73.6
Individuals	2.6	6.7	4.7	3.0	1.1	5.7	3.0	2.0
State and local govt.	15.5	39.9	26.3	22.2	5.5	30.7	27.8	9.6
Foreign official [2]	6.2	....	2.2	2.7	10.5	3.0	3.3	7.6
All other foreign	.7	....	.6	.3	1.1	.5	.8	.8
Other	6.0	5.5	6.5	10.7	3.0	5.5	4.5	6.5
Number of banks								
Total	238	59	119	40	20	150	56	32
Original purchaser:								
Businesses	226	52	117	37	20	139	55	32
Individuals	113	26	52	22	13	60	31	22
State and local govt.	139	32	66	31	10	76	41	22
Foreign official [2]	40	....	8	18	14	8	15	17
All other foreign	21	....	7	7	7	3	9	8
Other	91	10	48	22	11	41	29	21

Table continued on next page.

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TABLE 3—Continued

ORIGINAL PURCHASERS OF TIME CERTIFICATES OUTSTANDING ON DECEMBER 5, 1962

Original purchaser	Total reporting banks	Banks ranked by amount of— Total deposits (millions of dollars)				Total outstanding certificates [1] (millions of dollars)		
		Under 100	100–500	500–1,000	1,000 and over	Under 10	10–50	50 and over
	Certificates of $500,000 and over							
Amount (millions of dollars)								
Total	4,606	69	832	1,225	2,480	326	844	3,435
Original purchaser:								
Businesses	3,261	31	508	746	1,965	175	526	2,559
Individuals	69	3	23	17	26	12	12	45
State and local govt	624	32	222	274	96	105	231	288
Foreign official [2]	345	....	23	41	282	17	36	293
All other foreign	33	....	3	4	26	2	6	26
Other	275	3	53	144	75	16	34	225
Percentage distribution								
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Original purchaser:								
Businesses	70.8	44.9	61.1	60.9	79.9	53.7	62.3	74.5
Individuals	1.5	4.3	2.8	1.4	1.0	3.7	1.4	1.3
State and local govt	13.5	46.4	26.7	22.4	3.9	32.2	27.4	8.4
Foreign official [2]	7.5	....	2.8	3.3	11.4	5.2	4.3	8.5
All other foreign	.7	....	.4	.3	1.0	.6	.7	.8
Other	6.0	4.3	6.4	11.8	3.0	4.9	4.0	6.6
Number of banks								
Total	194	31	103	40	20	106	56	32
Original purchaser:								
Businesses	170	21	93	36	20	85	53	32
Individuals	35	5	15	6	9	14	8	13
State and local govt	99	13	52	25	9	43	36	20
Foreign official [2]	36	....	7	15	14	8	13	15
All other foreign	13	....	3	3	7	2	5	6
Other	43	4	18	11	10	13	12	18

[1] Banks issuing CD's were ranked according to their amounts of outstanding certificates in denominations of $100,000 or more.

[2] Foreign govts. and central banks and international financial institutions. See also Note to Table 1.

the total in any of the bank-size groups. Foreigners made almost all of their purchases at banks with deposits of $1 billion or over. They accounted for 10 per cent of the total outstanding at these large banks. Purchases by individuals were more significant at the smaller banks.

In general, business firms were more important purchasers of CD's of $500,000 and over than of denominations between $100,000 and $500,000. They accounted for about 70 per cent of the larger issues outstanding in late 1962 and only 60 per cent of the smaller denominations.

This pattern was not consistent, however, among banks of different deposit size. At

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banks with deposits under $100 million, for example, corporations and other businesses were less important as purchasers of the larger denominations than of the smaller ones.

CHARACTERISTICS OF CD'S

For CD's on which interest is paid, the interest ceilings imposed by Regulation Q have made those with maturities of 6 months and over the most competitive.[1] The maximum rates permitted on these certificates in recent years have been as follows:

Maturity (Months)	*Effective Jan. 1, 1957*	*Effective Jan. 1, 1962*
	(Per cent)	
12 and over	3	4
6-12	3	3½
3-6	2½	2½
Under 3	1	1

Foreign official deposits were exempted from Regulation Q ceilings for a 3-year period beginning with October 15, 1962. After that banks could offer competitive rates on the shorter-term maturities preferred by these depositors. Foreign official deposits did rise after this change, although only part of the increase took the form of negotiable CD's. And it would appear that most of these were in maturities of 6 months or longer.

The schedule of maximum rates had made certificates of deposit maturing in less than 6 months unattractive to domestic investors. For example, since late in the year 1961 3-month Treasury bills have been yielding more than the maximum rate of 2½ per cent on time deposits. At banks with deposits of less than $100 million, only 6 per cent of the total outstanding on December 5, 1962, had maturities of under 6 months. And at the larger banks, CD's in these short maturities were less than 3 per cent of the total outstanding.

In the secondary market, on the other hand, investors have been able to acquire CD's with less than 6 months remaining before maturity at favorable rates. Purchasers of issues initially maturing in 6 months or longer can sell them later on the secondary market to investors who want shorter-term issues, say of 2 or 3 months. The seller will realize a capital gain on sale of the certificate, while the price to the buyer still enables him to realize a higher yield than on U.S. Government securities of comparable maturity and a higher yield than could be obtained by originally placing funds with banks at less than 6-month maturity.

The most popular maturity range to the original holder was 6-9 months. This group accounted for almost half of the dollar volume outstanding. The next most important was the 1-year maturity. Larger banks had, in addition, a heavy concentration in 9-12-month issues. Issues of 1-year CD's were much less important to larger banks than to the smaller banks.

Issues maturing after 1 year were moderately important to each of the bank-size groups; at banks with deposits under $100 million they amounted to about 15 per cent of total CD's outstanding. There were 18 of the banks with outstanding CD's with maturities longer than 2 years. Only one of these was a bank with deposits of less than $100 million; most of them had deposits ranging between $100 million and $1 billion.

[1] Over 20 per cent of the banks reported they had some outstanding CD's on which no interest was being paid. The dollar volume, however, was only $35 million, or less than 1 per cent of the total.

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Most banks reported that they impose no formal restrictions on the resale of their certificates. Indeed, only 8 of the 270 issuing banks listed any such restrictions. Most of the issuing banks—199 of them—make certificates available only in "order" form, which makes them payable only to, or when endorsed by, the party named on the certificate. The others use both bearer forms and order forms; these banks were heavily concentrated in the larger bank-size groups.

Some banks also make it easier to redeem CD's at maturity by permitting holders to present them for redemption at a bank in another city. About a third of all banks with outstanding CD's offered this option to holders of their certificates. These banks accounted for a significant proportion of the total number of banks in each of the deposit-size groups.

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FEDERAL RESERVE SURVEY OF NEGOTIABLE
TIME CERTIFICATES OF DEPOSIT

Name of Bank ______________________ Federal Reserve District ____________

City and State ______________________ Date ______________________

The following questions refer only to negotiable time certificates of deposit issued by your bank. Upon completion, please return this form to:

Mr. ________________, Vice President,
Research Department,
Federal Reserve Bank of ____________,
____________, ____________.

I. Does your bank issue time certificates of deposit in a form in which they can be sold by the initial purchasers (that is, in negotiable form)?

Yes ☐ No ☐

If the above answer is no, disregard the remaining questions and return this form to the Federal Reserve Bank.

II. Does your bank issue any time certificates of deposit in bearer form?

Yes ☐ No ☐

III. Does your bank impose upon initial purchasers of negotiable time certificates any direct restrictions or any implied understandings which would restrict their resale of such certificates?

Yes ☐ No ☐

If yes, specify kinds of restrictions ______________________

____

____

IV. Indicate dollar volume (and in the last column, the number) of negotiable time certificates of deposit in different denominations (face value) outstanding on the dates shown below.

	Dec. 31, 1960	Dec. 30, 1961	Dec. 5, 1962	
Less then $100,000	$	$	$	
$100,000 - $499,999				No.
$500,000 and over				No.

If a single transaction involves several certificates, count them separately.

NOTE: The remaining questions refer only to negotiable certificates in denominations of $100,000 and over outstanding on December 5, 1962. If your bank did not have such certificates outstanding on this date, disregard the remaining questions and return this form to the Federal Reserve Bank.

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V. Indicate the total dollar amount, if any, of $100,000 and larger negotiable time certificates outstanding issued at a zero rate of interest $________.

VI. Indicate the dollar amount of $100,000 and larger negotiable time certificates of deposit outstanding with original maturity of:

Less than 6 months	$________
Six months and over, but less than 9 months	$________
Nine months and over, but less than one year	$________
One year	$________
Over one year	$________

Specify the longest original maturity on any certificate outstanding________

VII. Indicate the dollar amount of negotiable certificates of deposit outstanding according to original purchaser for the following two size brackets:

	$100,000-$499,999	$500,000 and over
Corporate and other business (financial and nonfinancial)	$________	$________
Personal	________	________
States and political subdivisions	________	________
Foreign		
Foreign governments, central banks, and international financial institutions	________	________
All other foreign	________	________
Other (incl. nonprofit)	________	________

VIII. Does your bank issue time certificates of deposit in denominations of $100,000 and larger in a form which permits redemption at maturity at a bank other than your own?

Yes ☐ No ☐

____
(Name of officer)

____
(Title)

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NATIONAL INDUSTRIAL CONFERENCE BOARD ASSERTS FEDERAL RESERVE BOARD ACTION OF DECEMBER 6, 1965, INCREASING DISCOUNT RATE AND REGULATION Q TO "BAIL OUT" MONEY MARKET BANKS

[From the Conference Board Record, January 1966, pp. 13-19]

The Increase in the Discount Rate: Timing, Motivations, Economic Effects

The increase in the Federal Reserve discount rate early last month was met with outspoken criticism by the Administration. In particular, the Administration insisted that the Federal Reserve Board should have waited until the release, this month, of the Economic Report for 1966 and the new budget for fiscal 1967.

The following analysis reveals not only that postponement of the rate increase until January would have been complicated by Treasury financing, but that it would have seriously aggravated several money market problems which had become more and more pressing toward the end of 1965.

The restraining effect of the rate increases on total economic activity for 1966 will probably be very modest relative to GNP, according to this analysis, provided the Federal Reserve abides by its promise to supply "additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses."

The analysis, by Dr. Michael E. Levy, manager of The Conference Board's Fiscal and Monetary Department, is part of the department's continuing survey of money market developments.

THE FEDERAL RESERVE BOARD's announcement on Sunday, December 5, 1965, that it had approved an increase in the discount rate from 4% to 4½%, effective December 6, received top billing in the nation's news media.[1] *The New York Times* of December 6, for example, front-paged the story under a three-column headline.

The dramatic reaction of the news media to this long expected Federal Reserve statement contrasted sharply with previous cursory treatment of such statements as just another item of financial news. Many an uninitiated observer may thus have been led to believe that the latest Federal Reserve action was totally unexpected and of grave economic consequences. This interpretation was underscored by the announcement of Congressional hearings by the Joint Economic Committee and by the initial stock market reaction. The market registered the highest opening volume since 1929 and shaved 17.60 off the Dow-Jones industrial average before recovering; it closed at a net daily loss of 6.57, with 11.44 million shares traded.

On sober second thoughts, these reactions to the increase in the discount rate must be viewed, not as prophecies of impending economic doom, but rather as doleful confessions that the 57-month old "honeymoon" between the Administration and the Federal Reserve Board had come to an end. As Vice President Hubert Humphrey put it several days after the event: "Monetary policy . . . was well coordinated for 57 months of the expansion; it was not coordinated this past week end."[2]

Toward the Showdown

To the initiated, the recent rise in the discount rate was largely a matter of timing. In the fall of 1965, the theme of "deterioration in the quality of credit" and a plea for "greater restraint" had been reiterated in speeches and public statements by Vice-chairman C. Canby Balderston and by other so-called "Martin supporters" within the Fed. At the same time, James L. Robertson and Sherman J. Maisel, members of the so-called "liberal" group of the Board of Governors, had

(Note: The author expresses his appreciation to Drs. Kenneth M. Wright, Robert H. Parks, Henry Kaufman, Thomas R. Atkinson, and Alan Greenspan for the opportunity to discuss this subject with them. But he is, of course, solely responsible for the present analysis and conclusions.)

[1] Specifically, the Board approved increases in the discount rates of the Federal Reserve Banks of New York and Chicago. (Other Federal Reserve banks soon followed suit). At the same time, the Fed raised to 5½% the maximum rate on member bank time deposits and certificates of deposit having a maturity of 30 days or more.

[2] An address before the 27th Annual Meeting of the Institute of Life Insurance, December 7, 1965.

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publicly voiced their opposition to any interest rate increases then; a third member of the Board, George W. Mitchell, was known to hold similar views.

Many well informed observers felt that the final showdown was close at hand. It was widely assumed that William McChesney Martin, Jr., Chairman of the Federal Reserve Board, would be able to count on solid support from Governors Balderston and Shepardson; J. Dewey Daane was considered open to persuasion. Thus, a four-to-three vote in favor of monetary restraint seemed the most likely outcome of any showdown, with Governors Robertson, Maisel, and Mitchell opposing the rate increase.[3] Since Vice-chairman Balderston's term expires on January 31st, 1966, the final showdown was bound to occur prior to that date.

Declaration of Independence

The Administration, well aware of this situation, embarked on a concerted public campaign against any tightening of the monetary reins. The Council of Economic Advisors (CEA) stressed repeatedly that unemployment was still undesirably high and that there were no indications of any impending inflation; according to the CEA, this was not the time to deviate from the past expansionary policies. This theme was repeated in speeches by Secretaries Connor, Wirtz, and Fowler.

To reinforce this position, President Johnson scheduled a top-level economic meeting at his Texas ranch for December 6th. Invited were Chairman Martin, Henry H. Fowler, Secretary of the Treasury, Gardner Ackley, Chairman of the Council of Economic Advisors, and Charles L. Schultze, Director of the Bureau of the Budget. Subsequent statements by the President suggested that the meeting had been designed, in part, to persuade Chairman Martin to delay any impending Federal Reserve action until after the release, in January, of the Economic Report of the President and the budget for fiscal 1967.[4] In view of the apparent reasonableness of such a request, the timing of the Federal Reserve action—a highly unusual Sunday announcement preceding the Presidential meeting by just one day—was likely to appear both arbitrary and offensive. To many observers, it was an open "declaration of independence."

[3] This was the actual outcome of the vote on the discount rate increase. The only surprise was the solid vote of Governor Daane in favor of the increase, with Chairman Martin providing the "swing vote."

[4] In commenting on the announcement of the discount rate increase on December 5th, President Johnson stated: "I particularly regret that this action was taken before January when we will have before us the full facts on next year's budget, Vietnam costs, housing starts, state and local spending and other elements in the economic outlook." (As reported in *The New York Times*, December 6, 1965.)

A Matter of Timing

To the initiated, the Administration's plea for a January delay was not quite as "non-committing," nor was the December Federal Reserve action quite as "rash" as the majority of general observers seem to have deemed it. Treasury cash balances in December were precariously low, indicating the need for a sizable January cash financing. At the time of this writing, this January financing is estimated at $1.5-$2.0 billion (with the higher figure the more likely one). A Treasury announcement is expected around January 3, with delivery around January 10. By January 26, the Treasury is likely to announce its February refunding, at which time it may have to raise another half-billion dollars. (Treasury cash needs in March are tentatively estimated at another $2 billion).

Thus, given the Federal Reserve's past sound procedure of not upsetting the money market at the time of a Treasury financing, there would have been at best an interval of several days in mid-January when the Federal Reserve Board could have raised the discount rate. If the release of the 1967 Federal budget were to be delayed well beyond mid-January (which has happened before), there might remain no time in January suitable for Federal Reserve action. The nomination by President Johnson of a new governor to replace Governor Balderston, whose term expires on January 31, is likely to change the internal balance of power of the Federal Reserve Board in February, making any future restraint more difficult. Moreover, a delay by the Fed until January would not have solved the serious problem of $3.5 billion commercial bank certificates of deposit that were maturing in December and could not be "rolled over" (i.e., renewed) at, or below, the 4½% interest rate ceiling of Regulation Q (for discussion of this problem, see below, page 18).

Thus, the Federal Reserve Board was faced with the alternatives of taking action sometime during the first half of December (during the second half of this month, the money market is too much in a state of flux to permit any policy changes)—or of resigning itself to a probable course of many months of inaction, with an unusually rapid expansion of money and credit. The choice was clear; the decision, telling. One may be disturbed by the timing of the announcement on a *Sunday*, preceding the special Presidential meeting by just one day. An announcement on Thursday, December 9, following a regular Board meeting, would have conformed more closely to Federal Reserve tradition and might have been less objectionable. But would it have been accorded a more congenial reception, coming but a few days after a major Presidential "essay in persuasion"?

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Why Higher Discount Rates?

Once the controversial and emotional issue of the timing of the Federal Reserve action is disposed of, the question of the intrinsic merit of higher discount and interest rates becomes the critical issue. The Administration's strong objections to higher interest rates have been based largely on the following three propositions:

(1) The unemployment rate is still too high to justify any restraint.

(2) Existing industrial reserve capacity permits further rapid economic expansion without inflation.

(3) Price stability has been preserved without any signs of impending inflation.

The present CEA, as well as many prominent economists, have strongly objected to past monetary policies of stepping on the brakes as a "preventive action" against a *threatening* inflation that has not yet been fully confirmed by the relevant statistical measures.[5]

But even this position became beclouded towards the end of 1965, as both the wholesale and the consumer price indexes registered increases well above the average for the first three years of this expansion. At the end of November, when the October figures were released, Arnold E. Chase, Assistant Commissioner for Prices and Living Conditions of the Bureau of Labor Statistics, conceded that the 1.8 point increase in the consumer price index from November, 1964, to October, 1965, "would appear to be as much a rate of increase as we should have."[6]

Around the time of the discount rate increase, the Administration's position in favor of continued monetary ease was challenged not only by the banking community (which is said to be always in favor of high interest rates), but also by a number of prominent economists, including two former chairmen of the Council of Economic Advisers. Arthur F. Burns, in his recent Benjamin F. Fairless Memorial Lecture at the Carnegie Institute of Technology,[7] took issue not only with the CEA's interpretation of the recent price advances, but also with its views on the unemployment and capacity data.

According to Dr. Burns, "unemployment has declined substantially, and is now largely concentrated among unskilled and inexperienced workers. As far as skilled labor is concerned, shortages have become extensive."[8]

With regard to capacity utilization, Dr. Burns observed that "in December 1964, the percentage was 88, and currently it is about 90—or merely 2 points below the reported optimum rate. Moreover, these figures are averages and therefore conceal the fact that manufacturers in numerous industries have for some time been operating at or above their optimum rates."[9]

Dr. Burns also voiced moderate concern over recent price and wage advances: "Prices of raw materials began advancing toward the end of 1963; but the overall index of wholesale prices still stood at 100, on a 1957-59 base, as late as June, 1964. Since then, price increases in wholesale markets have spread out over the economy, and the index has risen 3 percent. In recent months, the advance in wages has also shown a tendency to accelerate."[10]

The former Chairman of the CEA concluded with the following prescription: "The managers of our national prosperity will have the best chance of extending the current expansion if they will, on the one hand, deal more realistically with the structural causes of unemployment and, on the other, take steps to slow down the rate of growth of bank credit and curb for a while the increase of Federal spending on civilian programs." In a similar vein, Dr. Saulnier declared recently: "It would be clearly unwise to expose the U.S. economy to further doses of monetary expansionism, certainly not to a dose such as we have had in the past year. This means that monetary policy should move toward restraint."[11]

Business Week, a staunch supporter of the "new economic policy," reversed its position in late November and, in an editorial titled "Money policy: the case for restraint," pleaded for moderate monetary restraint now in order to avoid the need for drastic action later.[12]

Thus, toward the end of 1965, a substantial and growing body of expert opinion favored *moderate* monetary restraint. Most proponents of this position stressed the recent speed-up in price advances, the emergence of some bottlenecks in production and supply, and balance-of-payments considerations as the three major justifications for a shift in monetary policy.

The Federal Reserve Board's own statement also

[5] The extent to which prominent policy makers within the Federal Reserve differ from this position is clearly revealed in the following recent statement by Chairman William McChesney Martin: "To me, the effective time to act against inflationary pressures is when they are in the development stage—before they have become full-blown and the damage has been done. Precautionary measures are more likely to be effective than remedial action . . . It is simpler, for one thing, to try to prevent prices from rising than to attempt to roll them back." ("The Federal Reserve's Role in the Economy," an address before the 59th Annual Meeting of the Life Insurance Association of America, New York, Waldorf-Astoria Hotel, December 8, 1965.)

[6] As reported in *The New York Times*, December 1, 1965.

[7] Printed (slightly edited) in the Tax Foundation's *Tax Review*, Vol. XXVI, No. 11, November, 1965.

[8] *Loc. cit.*, p. 52.

[9] *Ibid.*

[10] *Ibid.*

[11] An address before the Federation of Women Share-Holders in American Business, New York, Waldorf-Astoria Hotel, November 9, 1965.

[12] *Business Week*, November 27, 1965, p. 140.

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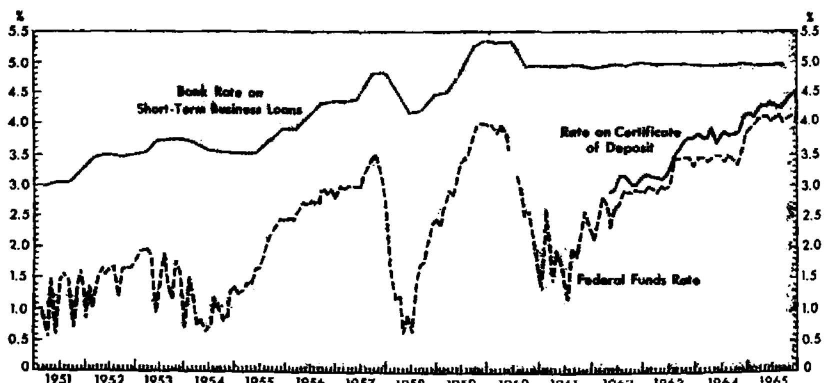
Chart 1: Major Money Market Rates—March, 1951-November, 1965



Note: The discount rate (New York Federal Reserve Bank), the prime rate, and the Treasury bill rate (rate on new issues of three month bills) are published monthly in the *Federal Reserve Bulletin*. The bank rate on short-term business loans is a weighted average based on loans of all sizes, for the first 15 days of the last month of each quarter for 19 large cities, as published in the *Federal Reserve Bulletin*. The Federal funds rate is an average of the daily "effective" rates, as collected by Garvin, Bantel & Co. The rate on certificates of deposit (available only since May, 1962) is a monthly average of weekly figures on secondary market rates for issues with a maturity of three months, as assembled and published by Salomon Brothers & Hutzler in *Short-term Market Rates of Interest from 1960.*

stressed the need to forestall the building up of inflationary pressures.[13] Nor was the Board unaware of balance-of-payments considerations.[14] But the Board alluded to two further developments of concern that justified the recent rate increases, yet have been largely ignored in previous, as well as in subsequent, discussions by others. They are:

(1) The sizable recent credit expansion had been supported to a disturbingly large extent by *bank borrowing*. (This almost implies that the commercial banks, not the Federal Reserve, "called the tune.")

(2) Certain money market rates had become "distorted" toward the end of 1965, especially in relation to capital market rates.

These two points deserve close scrutiny and will now be taken up in turn.

[13] As stated by the Federal Reserve Board, the actions were "intended not to cut back on the present pace of credit flows but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures." (As reported in *The New York Times*, December 6, 1965.)

[14] "Moreover, increases in costs and prices would make it more difficult for American goods to compete in markets at home and abroad." (*Ibid.*) For an elaboration on balance-of-payments considerations, as well as a statement of the other motivations for the Federal Reserve action, see William McChesney Martin, "The Federal Reserve's Role in the Economy," *op. cit.*

Calling the Tune

In the past, the Fed had frequently insisted that borrowing at the discount window was a bank privilege, not a "right." Requests for repeated or excessive borrowing could be denied at any time. Yet, in its announcement on December 5, 1965, the Federal Reserve Board asserted: "The increase in discount rates is intended to moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands."[15]

This statement seems to hint at a relatively *passive, accommodating* role of the Fed in absence of the discount rate increase—and at concommittant potential excesses in credit expansion. This implicit confession of partial impotence becomes even more obvious in the following assertion:

"Since then [November, 1964], total borrowing by consumers, business and state and local governments has risen sharply, and interest rates at all maturities from the shortest to the longest have been rising under demand pressures. In these circumstances, the Federal Reserve *would be forced to increase bank reserves at an accelerated pace* if all demands for borrowing money at present rates were to be satisfied."[16]

[15] As reprinted in *The New York Times*, December 6, 1965.

[16] *Ibid.*, italics supplied.

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Are we alerted to a situation where the commercial banks call the tune and the Federal Reserve is *forced* to "pay the piper," i.e., supply the reserves? In October, 1965, the Treasury bill rate moved above the discount rate; the Federal Funds rate had been above 4% ever since March of that year (see Chart 1). Bank financing through certificates of deposit became more and more difficult as the CD rate "bumped" against the 4-½% rate ceiling on time deposits. Hence, supply and cost considerations increasingly forced the commercial banks to borrow from the discount window in order to finance their rapidly rising loans and investments.

Thus, while for the first four years of the expansion the Federal Reserve had followed a policy of *active ease*, pumping reserves into the system through voluntary open market purchases, it now found itself in a position of *passive but moderate, restraint*, where member bank borrowers had to be turned away *selectively* and where open market operations were dictated by the need to *"monetize"* bank borrowing. This is clearly revealed by the basic statistics. Monthly borrowings of all member banks averaged $450 million during the year ending October, 1965 (the latest date for which data are available at the time of this writing), up from $292 million during the comparable 1963-64 period, $225 million during 1962-63, and $90 million during 1961-62 (see the table). During the six months, May-October, 1965, average monthly borrowings rose further to $523 million. Despite these persistent increases in borrowing from the Fed, monthly net borrowed reserves (i.e., the amount by which borrowings from the Fed exceeded "excess reserves") averaged only $75 million during the year ending in October, 1965, and around $163 million during the last half of this period. As the banks borrowed, the Federal Reserve—apparently reluctant to let net borrowed reserves pile up beyond the $150-180 million range—replenished bank reserves through open market purchases.[17] Thus, the discount window served as a selective "feeder line" through which the rapidly swelling volume of credit and money supply was supplied with its life-blood—bank reserves.

Yet, some restraint was exercised. Some banks ran into increasing difficulties in their attempts to borrow—or were turned away. The Fed was bound to view with concern a process of monetary control that had to rely more and more on *selective* denial of access to the discount window. Clearly, the appropriate means of reasserting active control in the money market was an increase in the discount rate well above the prevailing Treasury bill and Federal funds rates. Hence the increase in the discount rate by a full 50 points to 4½%, the highest discount rate since 1930.

Removing Rate Distortions

The recent rise in the Treasury bill and Federal funds rates above the discount rate was not the only "distortion" of rates in the money and capital markets. The commercial banks' "prime rate" had remained at 4.50% from August, 1960, to November, 1965—and the average rate on all short-term business loans had hovered close to 5.00%—while the discount rate had been raised twice, from 3.00% to 3.50%,and then to 4.00% (see Chart 1).[18]
Meanwhile, the Treasury bill rate had advanced from 2.286 to 4.082; and the Federal funds rate, from 3.06% to 4.10%. The rate on CD's had risen from 2.94% in May, 1962 (the first date for which this series is available), to 4.47% in November, 1965. Thus, commercial bank *profit margins* had to suffer from one of the most intense squeezes in recent history.

[17] The reluctance of the Fed to let net borrowed reserves pile up—clearly revealed by the relevant data—can be understood only in terms of the past Federal Reserve tradition, where net borrowed reserves of $500 million would already imply severe stringency.

[18] The increases in the discount rate of the Federal Reserve Bank of New York became effective July 17, 1963, and November 24, 1964, respectively. The preceding 3.00% rate dates back to August 12, 1960. The prime rate of 4.50% was established on August 23, 1960.

Factors Affecting Member Bank Reserves During the Current Expansion

(Millions of Dollars)

Year Ending in:	Changes in:			Average Monthly:			Increase in:	
	Gov't. Securities Held by Federal Reserve Banks (1)	Gold Stock (2)	Currency in Circulation (3)	Float (4)	Borrowings from Federal Reserve (5)	Net Free (+) or Borrowed (−) Reserves (6)	Required Reserves (7)	Total Reserves (8)
October, 1962......	2,197	−1,278	1,246	1,531	90	435	568	545
October, 1963......	2,407	− 468	2,009	1,724	225	240	− 125	− 201
October, 1964......	2,686	− 120	2,241	1,875	292	114	1,024	1,029
October, 1965......	4,267	−1,605	2,371	1,828	450	− 75	1,001	923

Sources: Federal Reserve; The Conference Board

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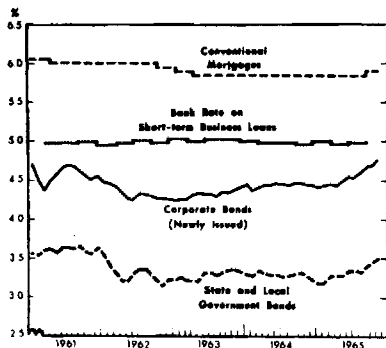
Chart 2: The Bank Rate on Business Loans and Major Capital Market Yields— January, 1961-November, 1965



Note: For the rate on short-term business loans, see note to Chart 1. The yield on corporate bonds (newly issued) is a monthly average of weekly Friday quotes on recently issued Aa (Moody rated) corporate bonds as collected and published by the Federal Housing Administration, which also publishes the yield on conventional first mortgages (existing homes). Moody's yield series on state and local government bonds, based on Thursday closing quotes of a limited number of suitable bonds rated A, Aa, Aaa, and Baa, is published in *Moody's Governments and Municipals* and in the *Federal Reserve Bulletin*.

An earlier attempt at raising the prime rate in December, 1964 (shortly after the Fed's discount rate increase from 3.50% to 4.00%), had collapsed under strong White House pressure to keep interest rates stable. The banks were not likely to try again, unless the Fed led the way with a further discount rate increase.[19] In the meantime, they tried to protect, or even improve, *the level* of profits by shifting from short-term Governments into higher yielding loans and investments and by borrowing from the Fed in order to expand their total *volume* of loans and investments.

This atmosphere of intense bank competition for high volume at exceedingly small profit margins led—according to many critical observers—to some relaxation of customary credit standards, often described as a "deterioration in the quality of credit." The pressures became severe in late 1965, when business demand for short-term and term loans was intensified because of the growing distortion between sticky loan rates—linked by institutional tradition to the prime rate—and rapidly rising rates on newly issued corporate bonds and other capital-market issues (see Chart 2).

At the same time, the rates paid even by the largest banks on certificates of deposit (CD's) started "bumping" against the 4½% legal ceiling of Regulation Q (especially in October and November, 1965), and the smaller banks that have to offer a premium on their CD's were squeezed out of this market.[20] Moreover in December, 1965, about *$3.5 billion* CD's (out of an estimated total of $16 billion) were to mature. Money market experts were fully aware that not more than a tiny fraction of this amount could be rolled over at 4½%.[21]

The Federal Reserve could meet this problem either by a massive injection of bank reserves, designed to enable the banks to "pay off" the maturing CD's through the creation of additional demand deposits, or the Fed could have raised the interest rate ceiling of Regulation Q. The former solution could be ruled out in an environment of rapid money and credit expansion and accelerated price advances.[22]

Had the Board raised the interest rate ceiling on time deposits without raising the discount rate at that time, it would have put the money market on notice that further adjustments were to follow soon, a procedure of questionable merit. Moreover, it is unlikely that the banks would have dared to raise the prime rate without a preceding discount rate increase. Squeezed between a CD rate of 4¾% and a prime rate of 4½%, they would have been forced to lend to the highest risk borrowers, eliminating all new prime borrowers.

Dissatisfied with this "temporary" solution, the Federal Reserve Board approved a "package" that included both the discount rate increase and the increase in the ceiling rate on time deposits. The ceiling rate on savings deposits was retained at 4%, in order to forestall a new round of competition for savings deposits among commercial banks, mutual savings banks, and savings and loan associations which could disrupt the flow of funds to the mortgage market.[22a]

[19] In fact, shortly after the December 6, 1965 discount rate increase, the banks raised the prime rate to 5.00%.

[20] That the Federal Reserve Board was well aware of this problem is attested by Chairman Martin's address on December 8, 1965 (*op. cit.*).

[21] In fact, when the Federal Reserve Board raised the legal interest rate ceiling on 30-day time deposits from 4½% to 5½%—effective December 6, 1965—the rate on CD's advanced almost immediately to 4¾%.

[22] It is interesting to note that the increase in the time deposit rate ceiling was approved by a Federal Reserve vote of 6 to 1, with Governor Robertson the sole dissenter.

[22a] However, the Franklin National Bank, a large eastern commercial bank, has already increased the interest rate paid on its so-called "savings bonds" to 4.80%. These "savings bonds" basically consist of saving deposits of small depositors who agree to leave these deposits at the bank for a specified minimum period (ranging from 90 days to five years). The smallest denomination is a "discount bond" available for $19.69 (see *The New York Times*, December 21, 1965), in direct competition with savings deposits at mutual savings banks and savings and loan associations.

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Economic Effects

At this point, economists and business forecasters are likely to be more interested in the economic effects of the recent rate increases than in their motivation. These effects should be considered under two separate headings: (a) money-market effects, and (b) impact on total economic activity.

Money-market Effects

The preceding discussion referred to three important money-market effects of the rate increases, which may be summarized briefly:

(1) The increase of the discount rate above the Treasury bill rate and Federal funds rate is bound to re-establish active monetary control by the Federal Reserve through open-market operations, with reduced bank reliance on borrowing (especially in conjunction with the increase in the rate ceiling on time deposits).

(2) Higher lending rates and improved profit margins of the commercial banks are likely to induce a change in the bank loan "mix," favoring again high-quality, low-risk borrowers.

(3) The increase in bank lending rates is bound to reduce the attractiveness of term loans as a means of corporate finance relative to new bond issues in the capital market. This is likely to stimulate new bond issues, especially in the short run.[23]

Effect on Economic Activity

Present economic know-how does not provide any standard set of tools that would permit a generally acceptable assessment of the effect of the recent rate increases on aggregate demand and total economic activity. In technical economic jargon, this effect depends largely on the "interest elasticity" of consumption and investment, or on the impact of reduced "credit availability." Empirical evidence on this subject is meager and inconclusive but suggests, at most, a very modest effect.[24]

This author was unable to find any expert on this subject who would estimate the net economic restraint for 1966 at more than $1 billion—assuming the Federal Reserve abides by its promise to continue "provisions of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses."[25] The estimates of a small sample of experts (with whom the author agrees) place the net restraining effect at $250-1,000 million, that is, at *less than 15/100 of one percent of projected GNP.* This means that there will be a few marginal borrowers who will be squeezed out by the rate increases, but, as one bank economist put it: "While we all believe in the existence of these marginal borrowers, we seem to be unable to locate them."

Even if the restraining effect of the recent rate increase should be about 3/10 of one percent of GNP—more than twice the amount suggested here—the obvious conclusions still remains that *economic forecasters will be well advised to focus on Federal expenditures and the budget deficit for fiscal 1967 rather than on the Federal Reserve discount rate.*

MICHAEL E. LEVY, *Manager*
Fiscal and Monetary Department

[23] If corporate Treasurers expect further upward adjustments in market rates, the supply of corporate bonds could be accelerated considerably during the next 4-6 months.

[24] For a recent review of this issue and bibliographical references, see Michael E. Levy, *Cycles in Government Securities: II. Determinants of Changes in Ownership,* New York, NICB, 1965, esp. pp. 119-28.

[25] Federal Reserve Board statement, as reported in *The New York Times,* December 6, 1965. Several experts have indicated that—despite this statement of intent—they expect the Fed to reduce the rate of expansion of money and credit in 1966 well below the 1964 and 1965 pace. Based on this assumption of greater monetary restraint (in terms of smaller "credit availability"), one economist assessed the dampening effect on 1966 real GNP at as much as $3 billion (the highest figure yet mentioned to this author).

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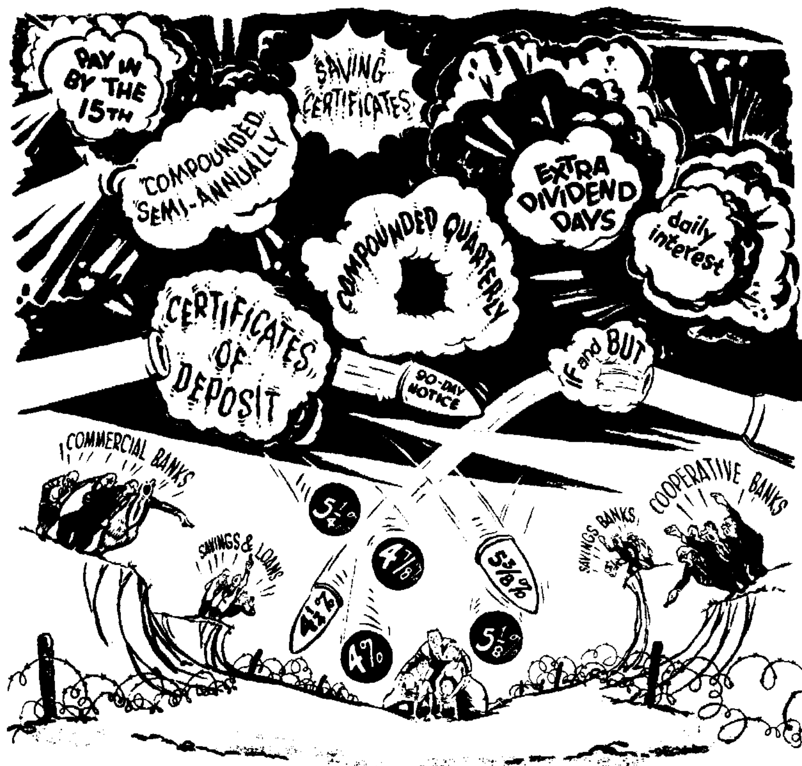

Keep your family out of the crossfire!

A useless war is now going on over interest rates on savings. Like other wars, there can be no winner. Certainly not you and your family.

What to do?

Keep calm. Stop switching your savings from place to place just to earn a dollar or two extra in interest a year. Rates that go up can also come down.

If gambling is in your blood, go play poker or bet on the horses.

If you want to do some serious investing, go see a good stock broker. Or dabble in real estate. This is what risk capital is for.

But remember — we savings institutions are thrift institutions, not investment houses. Our dividends (whether 4% or 5%) are not designed to make you rich. They are designed to encourage you to save the money that will make you rich.

Say you now have $500 in a savings account. A year from today dividends will have probably added $20 or $25 to that amount. *But* — if you save just two dollars a week, you'll have close to $650.

This is thrift. It's what sends youngsters to college, pays for vacations (cheaper when you pay cash) and makes the retirement years happy and worry free.

Be wary, too, of the so-called "90-day notice" account. This is where the bank says something like, "Promise not to touch your savings for 6 months or a year, and we'll pay you an extra half of one percent."

The trouble here is you then have to give the bank 90-day advance notice before you can get your money. (How many of us know when we're going to need emergency cash **90 days in advance!**)

While the rate war rages, our advice is simple and sound. Keep your head — and keep saving whatever dollars you can. And keep your money where it's safe, insured, convenient, and always available at a moment's notice.

And have a nice summer.

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[From Finance magazine, May 1966]

SHOULD NEGOTIABLE CD'S BE OUTLAWED?—YES

(By Congressman Wright Patman, (Democrat of Texas) Chairman, House Banking and Currency Committee)

An innocent sounding phrase, Certificate of Deposit, which was barely part of the banking vocabulary five years ago, today is producing some of the biggest headaches in financial history.

Negotiable certificates of deposit are a prime factor in the escalating interest rate war which is ripping apart many sectors of the banking and thrift industries. They are the big push behind leapfrogging interest rates which are sending credit costs to historic heights in all areas of the nation. Certificates of deposit are placing the Federal Government—or more correctly, the American taxpayer—at a severe competitive disadvantage in managing the public debt. At the same time, these new credit instruments are a serious threat to the solvency of many financial institutions—including the very banks which produced them in the first place.

In short, certificates of deposit, which the Federal bank supervisory agencies have allowed to grow into a financial monster, today are a major threat to the public interest and the banking interest of the country. That is why I have proposed legislation which would outlaw these negotiable certificates of deposit and return the banking industry to a semblance of sanity in the handling of short-term time deposits.

CD IS A MISNOMER

The phrase "negotiable certificate of deposit" is, in my opinion, a misnomer. In reality these certificates represent nothing less than interest-bearing currency being issued by banks. This is bad public policy.

The situation recalls the wildcat banks which issued their own currency in an unrestrained and irresponsible fashion in the 1800's. The country put a stop to this wildcatting with the National Bank Act in 1862 following a series of financial panics. Now, just 100 years later, the banks, using negotiable certificates of deposit as their printing presses, in effect are again issuing currency. These modern-day wildcats have actually improved on the devices of the old financial barons by adding interest to the currency they issue.

While some banks publicly defend the certificates of deposit, I am convinced that privately a great many bankers are worried and are now coming to realize that they have a tiger by the tail and are either unable or afraid to let go. The CD's have grown at a fantastic rate. In 1961, there was barely $1 billion in negotiable certificates of deposit nationwide. Today the figure has skyrocketed to over $16 billion.

FED RATE INCREASE

Significantly, at the time of the Federal Reserve interest rate increase last December, only 245 banks accounted for all the outstanding CD's. Even more significant, only 30 large banks—those with a billion dollars or more in deposits—accounted for almost 75 percent of all the CD's, about $12 billion worth. Almost all of this $12 billion was held in the New York and Chicago Federal Reserve Districts.

It costs a great deal to get CD funds. In recent months, we have witnessed banks and other financial institutions leaping over each other in offering bigger and bigger interest inducements on certificates of deposit. Today, many banks have jumped to the limit and are offering 5½ percent on time deposits. This naturally forces the banks to seek higher and higher yields, which leads to riskier (and even unsound) loans to profit on this high-cost money.

Much of this high-cost money is what has been referred to as "fast-buck," "fast-moving," or "hot" money. By this, I mean money which moves rapidly in and out of the banking system and which carries a high price tag.

HIGH-POWERED MONEY

This is also what the banking industry calls "high-powered" money. This phrase comes from the fact that CD's provide reserves on which the banking system can make loans at a ratio of 25 to 1. So a million dollars in CD's can

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add a whopping $25 million to the loan-making power of a bank. This works fine so long as the bank is able to hang on to the $1 million in CD money.

But a great deal of this money invested in CD's is nothing more than temporary cash surpluses held by large corporations. These corporations can and do suddenly demand their CD money to meet payrolls, to pay taxes, to buy equipment, and for any purpose requiring ready cash. It is obvious that a sudden withdrawal of this type of money can have devastating effects on any bank, no matter how soundly managed otherwise. It is a well-publicized fact that certificates of deposit have played prominent roles in costly failures of several banks in recent years. The CD's have become a favorite tool of money brokers and the fast-buck speculators. Without question, this instrument of high-cost, fast-moving money is an unhealthy element in banking.

The widespread use of certificates of deposit is causing untold damage to many small financial institutions throughout the country. The big banks, desperate to hang on to the CD's are willing to jack up interest rates to the maximum. Faced with this severe competition, the smaller banks, savings and loan institutions, and other thrift organizations across the country lose their deposits to big banks willing and able to pay the highest price for time deposits.

DOWN THE DRAIN

This drain of funds is causing unnecessary injury to these smaller financial institutions and is resulting in an unhealthy imbalance in favor of the larger banks, chiefly those in New York. This means that in other parts of the nation, farmers, homeowners, small businessmen and consumers are finding it harder and harder to obtain loans at their local institutions.

The American taxpayer and the Federal Government likewise are being hit hard by the banks' battle over certificates of deposit. The effect on financing Federal expenditures has been extremely detrimental and expensive for the taxpayer. It is no secret that the Government bond market is demoralized. Recent bond prices have been at their lowest in 30 to 40 years. The Treasury Department has informed the Banking and Currency Committee that the negotiable certificates of deposit are a main factor in the Government's low bond prices and the current high cost of financing the public debt, including expenditures for the war in Vietnam.

Today huge sums which might otherwise have been invested in short-term U.S. Treasury securities are instead being channeled to the high priced, 5½ percent certificates of deposit issued by the commercial banks. This competition has forced short-term Treasury borrowing to an all-time high of just under 5 percent.

CD SQUEEZE

So we have the smaller financial institutions, the consumer, and the taxpayer caught in the squeeze over certificates of deposit. And even the big banks which have dabbled most heavily in this game of financial Russian roulette seem confused and fearful of letting go of this loaded gun.

The Federal Reserve Board, which presumably is responsible for controlling such a runaway situation, has played a variety of roles, all of which have served to throw gasoline on the fire. First, the Federal Reserve Board sat idly by while the certificates of deposit grew bigger and bigger in the banking industry. Apparently fearful of alienating their big banker allies, the Federal Reserve did not even issue a timid warning. I am convinced that the Federal Reserve Board should have taken direct action to stop the certificates before they become a major banking problem. Instead, they followed their traditional course of "doing what the banks want us to do."

This indulgent attitude brought both the Board and the big banks up against the wall late last year. Having ignored the certificate of deposit issue for so many months, the Fed was faced with finding some means of bailing out the big banks which at the time held more than $16 billion in the certificates.

The answer came in the form of the Federal Reserve Board's December 3 decision to allow the banks to pay a maximum of 5½ percent interest on time deposits including certificates of deposits. Previously, the maximum had been 4 percent for time deposits of less than 180 days and 4½ percent for time deposits held more than 180 days. This gave the banks an opportunity to raise interest rates by as much as 37½ percent on certificates of deposit.

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Today certificates of deposit, particularly those issued by the larger banks, are once again bumping against the uppermost interest rate limits. Once again the banks are faced with the severe problem of keeping these deposits, and they are almost certain to return to the Federal Reserve Board asking for another round of interest rate increases.

I am convinced that the Congress must move now to ban the negotiable certificate of deposit before they cause irreparable harm to the public and to financial institutions.

SHOULD NEGOTIABLE CD'S BE OUTLAWED—NO

(By Dr. Carter Golembe, Washington Economic Consultant, the American Bankers Association)

The negotiable certificate of deposit represents a significant innovation in financial markets. Its development and use by commercial banks during the past five years has led to more effective competition among financial institutions and a more productive allocation of resources. As with any major innovation, there is risk and accompanying market difficulties. But to prohibit the use of this new instrument would make as little sense as to have banned jet airplanes because they created difficulties for airport managements, caused safety and noise problems, and discomfited airline competitors.

There is nothing novel about the CD, nor are the reasons for its introduction and subsequent growth surprising. Certificates of deposit are probably as old as the commercial banking industry itself, and even in 1961 negotiable certificates were not unknown. But in that year commercial banks, especially the larger banks in the money market centers, began to promote actively the sale of large-denomination, negotiable certificates to corporations and other holders of large balances. At the same time, a secondary market developed which enabled holders to liquidate these securities prior to maturity. Whereas in 1961, negotiable certificate deposits were probably about $1 billion, most recent data indicate they exceed $16 billion.

WHAT'S BEHIND CD'S?

Reasons are not hard to find. Since World War II, the commercial bank position among all financial institutions had steadily deteriorated. In 1945, for example, commercial bank assets accounted for 86 percent of the total assets of commercial banks, mutual savings banks, savings and loan associations, and credit unions; by 1960, the commercial banks' share had declined to 69 percent. This was due to a number of factors, most prominent of which were the slow growth of demand deposits and the aggressive solicitation of savings by non-bank financial institutions. During the past 20 years, demand deposits have grown at an average rate of 2.1 percent per year—and in money market centers such as New York and Chicago they hardly grew at all. During the same period mutual savings banks have grown at an annual rate of 6 percent, savings and loans at 14 percent, and credit unions at 17 percent. Further, in recent years corporate treasurers were becoming increasing reluctant to leave temporarily idle balances in non-interest-bearing demand accounts. If commercial banks—particularly those in the larger cities—were to meet the increasing credit demands of a rapidly developing economy, they had to be able to compete more effectively for time funds.

From the point of view of the economy, the development of the CD had one very important effect. A portion of the balances which previously had gone into specialized instruments or institutions are now going into commercial banks and from there flowing out to the sectors of the economy most in need of credit. The market place, through the time-honored mechanism of price (here, interest) is efficiently channelling funds into their most productive uses. Unless one is prepared to argue that these funds would be used more productively in the stock market, the bill market, the commercial paper market, or by savings and loan associations, then it must be conceded that commercial banks—as multi-purpose lenders occupying a pivotal position in the economy—have introduced a needed element of flexibility into credit allocation.

Why, then, should anyone now seek to prohibit the use of this instrument? The reasons most frequently advanced are so varied—and so contradictory—that it would require writing a book to answer them all one by one. Broadly speaking, however, they seem to reflect two beliefs, identifiable as the "Devil" theory and the "Save-the-Bankers-from-Themselves" theory.

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The first of these propositions seeks to attribute all of today's financial stresses and strains to the new devil—the negotiable certificate of deposit. If short-term rates are high, then it must be because of rates paid on CD's. If the bond market is weak, then it must be because commercial bankers are pulling in funds through CD's. If small banks have difficulty acquiring funds, then it must be due to CD's issued by large, city banks.

But in reality, the explanation for these and other developments is simply that we have a booming economy straining against its productive capacity, coupled with some effort by monetary authorities to guard against inflation. The situation today is no different than on prior occasions when the same factors have been present. One has only to recall 1956–57 for a similar period—a time when negotiable certificates of deposit were virtually unknown. Indeed, it can be argued with some cogency that by introducing a finely-honed, flexible instrument into the money market, commercial banks have contributed to market stability. And so far as small banks are concerned, the large denominations of CD's and the nature of the typical investor make it clear that the CD competes with other money market instruments and not with savings accounts in small town banks.

The "Save-the-Bankers-from-Themselves" theory has a variety of forms. Essentially it stems from a piece of folklore, to the effect that all of the difficulties of the commercial banks in the 1920's and in the subsequent depression were due to high rates on both savings and demand deposits. As a consequence, banks tended to invest in high-yield, risky assets which eventually led to their downfall. The fact that no serious study has been able to validate this contention—and, indeed, typically shows that it is groundless—has not failed to down the theory. Recently, its advocates have pointed to the failure of a handful of small banks and the use by these banks of negotiable certificates of deposit, as further proof. But the fact is that in most of these cases the failures occurred soon after unscrupulous individuals acquired the bank, and used the negotiable CD, among other devices, to loot the institution. In none of these failures can support be found for the contention that interest payments were the principal cause of the bank's difficulty.

But, regardless of past history, there is not the slightest evidence to show that the funds acquired through the issuance of CD's are being used unwisely, or that there has been a deterioration in the quality of credit. Indeed, the contrary is almost certainly the case, for, as one of the nation's most respected bank supervisors—Howard Crosse, then of the New York Federal Reserve Bank—pointed out last year: "The CD . . . has brought more of the money that used to be invested directly by corporate treasurers in the bill market, or commercial paper, or other instruments, into commercial banking channels where its use is screened by experienced commercial bank credit officers. As a result, both as bank supervisors and as central bankers, we expect and, in fact, find that the quality of credit has been improved. In the vast majority of cases we think that CD proceeds have been used to make safe and productive loans."

Used unwisely, CD's can cause difficulties for banks. While a portion can be relied on to remain, some part will be particularly volatile. But the same is true of demand deposits, as well as other types of deposits held by commercial banks. and in the final analysis a bank succeeds or fails not because of the nature of its liabilities but because of the quality of its assets. There is more reason to believe that bankers are capable of handling these funds than are some others who receive them, and it must not be forgotten that banks, unlike some others. are also subject to strict and vigilant regulation by Federal and State authorities.

[From Banking, February 1966]

CD's a Problem for the Fed

In this month's pending problem, Herbert Bratter, Banking's Washington correspondent, describes how, from the Fed's point of view, negotiable CD's could affect the banking structure and the distribution of bank credit

Negotiable time certificates of deposit became a significant money market instrument in February 1961 when the First National City Bank, New York City, announced it would seek such business. Ever since then the Federal Reserve System has been closely following CD developments through the Board's staff

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and special System committees. Citibank's 1961 decision was of course quickly emulated by other big New York City banks seeking to attract corporate short-term funds through this newly-important money market instrument.

The Fed was aware that the issuance of negotiable CD's in large denominations, attracting funds which otherwise would be invested in readily marketable Treasury bills or prime commercial paper, might influence the terms and conditions under which short-term U.S. Government securities are bought and sold.

Before long, trading in negotiable CD's had become an integral part of money market activity. From the Fed's viewpoint these instruments could affect the banking structure and lead to significant changes in the volume or distribution of bank credit and money.

FED MUST BE INFORMED

The Fed's authority to regulate the rates paid on CD's necessitated its keeping itself informed on developments, since readily marketable CD's issued in large denominations by well-known banks compete directly with short-term Treasuries, commercial paper, sales finance company paper, and bankers' acceptances. Development of a secondary market with Government securities dealers at its center added a new dimension to the money market and to the environment in which the open market desk operates.

To increase their marketability, some CD's issued by banks outside of New York are made payable through correspondents in that city. To facilitate secondary trading big deposits normally are represented by CD's no larger than $1,000,000. Transactions usually are settled in Federal funds. The Fed early recognized that the volume of CD's would be strongly influenced by interest rates on competing securities and that the CD market would be dependent on whatever changes might be made in Regulation Q.

RESERVE POSITION

The Fed also is interested in the fact that, unlike other money market instruments, variations in the amounts of negotiable CD's outstanding influence the reserve position of banks. Transactions in ordinary open-market paper normally do not entail any change in bank reserves since all that is involved is an exchange of demand deposits. Acquisition of a negotiable CD, however, may involve a switch from demand to time deposits and hence an immediate reduction of bank reserve requirements.

In addition, CD's have implications for bank supervision, one of the Fed's responsibilities, raising questions related to general bank liquidity and safety. Thus, several different aspects of Fed monetary policy simultaneously affect, or are affected by, negotiable CD's.

Issuing banks have considerable control over the inflow of CD funds through the interest rates they pay thereon. For CD's to be profitable the issuing banks must invest the proceeds in higher earning, hence usually longer-term assets than, e.g., Treasury bills. Problems of bank examination and supervision may ensue.

SPECIAL ASPECT

One special aspect of negotiable CD's is present when, as in link financing arrangements, a borrower required to leave a compensating balance with its bank does so in the form of non-interest-bearing negotiable CD's on which the borrower in effect pays interest. Another special aspect of concern to the Fed is the impact of negotiable CD's on the competitive position of medium-size and big banks. The latter have two advantages. Their CD's are more marketable and they can more readily issue certificates in large amounts appropriate for the secondary market. To compete, medium-size banks may need to offer premium rates.

The rapid development of the negotiable CD market has had implications for the Federal Reserve's discount facilities. Until recent years banks used the money market to buy and sell investments, not as a major source of funds to supplement deposits. Through negotiable CD's big banks can bid on the national market for loanable funds with resultant greater flexibility. When such a bank suffers a decline in deposits it may at least to some extent raise money through CD's by offering a higher rate of interest.

Under some circumstances this may introduce potential vulnerability. For, the more a bank is dependent on borrowed funds, the greater the risk that it may incur a sharp increase in costs or a substantial drain of funds when the

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availability of money contracts. Banks could then turn to the Fed's discount facilities on a large scale.

This is where the Fed's Regulation Q plays a role. Its ceiling on interest rates on time deposits may have the salutory effect of restraining bank issuance of CD's. If, however, the ceiling rate is unrealistic and the volume of CD's outstanding is very great, as was the case last autumn, a serious problem may confront the money managers in Washington. With the prospect that banks facing large early maturities of outstanding CD's would be unable to renew them because of the Regulation Q ceiling, the Board by lifting the ceiling to 5½% in effect removed it. If this action had not been taken, the entire financial system—not just the money market banks—could have been subjected to severe pressure.

BANKS WERE SEARCHING FOR SUBSTITUTES

Long before the threatened crisis of early December 1965 the banks using negotiable CD's were aware of their vulnerability to a rise in money market interest rates and were searching for substitutes. In the weeks preceding the November 24, 1964, increase in Regulation Q ceilings, banks feared that the Fed would not act soon enough and that they would have to either liquidate assets at an undesirable pace or else turn down requests for new loans. Many banks sought a solution in negotiable unsecured notes, even though most banks prefer not to show heavy borrowings on their statements.

National banks, being limited in the amount of such notes they may issue, prefer not to exhaust this emergency source of funds, despite the obvious advantages of such a substitute for CD's—no reserve requirements and no FDIC assessment. Restrictions on borrowing by both national and state banks have therefore tended to limit the substitution of unsecured notes for CD's. Nevertheless Regulation Q hase been the chief stimulus to the development of a market for negotiable notes; and it has tended to introduce distortions into the money market.

Thus, Q has tended to make the slope of the yield curve somewhat steeper and has made bank managements more conservative in their investment policies. This may have tended to force a bigger part of total financing into nonmoney-market banks and nonbank financial intermediaries which are less directly influenced by the money managers of the Fed. Hence the net restraint on the availability of credit from all sources together may be less than might be shown in the assets of the banking system alone and the impact on banks of different sizes may be significant. All this is of concern to Fed policy makers.

[Federal Reserve press release, Dec. 6, 1965]

The Federal Reserve announced today two complementary actions to reinforce efforts to maintain price stability, and thus to foster balance in the economy's continued growth and strength in the dollar's international standing.

The actions, intended not to cut back on the present pace of credit flows but to dampen mounting demands on banks for still further credit extensions that might add to inflationary pressures, were as follows:

1. The Board of Governors in Washington approved actions by the directors of the Federal Reserve Banks of New York and Chicago increasing the discount rates of those banks from 4 to 4½ percent, effective Monday, December 6, 1965. The discount rate is the interest rate charged member Banks for borrowing from their district Federal Reserve Banks.

2. Simultaneously, the Board increased the maximum rates that member banks are permitted to pay their depositors to 5½ percent on all time deposits and certificates of deposit having a maturity of 30 days or more. This change is also effective Monday, December 6. Previously, the maximum rates payable were 4 percent for time deposits and certificates of 30 to 90 days and 4½ percent on those of 90 days or more. No change was made in the rate payable on savings deposits (4 percent).

The increase in the rates that member banks are permitted to pay their depositors is intended to enable the banks to attract and retain deposits of businesses and individuals and thus to make more effective use of savings funds already available in the economy to finance their loan expansion.

The increase in discount rates is intended to moderate additional bank reliance on short-term borrowings from the Federal Reserve to meet intensifying loan demands.

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The action contemplates, however, the continued provision of additional reserves to the banking system, in amounts sufficient to meet seasonal pressures as well as the credit needs of an expanding economy without promoting inflationary excesses, primarily through the Federal Reserve's day-in and day-out purchases of government securities in the open market.

The changes in discount rates and the maximum rates that banks may pay depositors were the first in either respect since November 24, 1964.

Since then, total borrowing by consumers, business, and State and local governments has risen sharply, and interest rates at all maturities from the shortest to the longest have been rising under demand pressures. In these circumstances, the Federal Reserve would be forced to increase bank reserves at an accelerated pace if all demands for borrowing money at present rates were to be satisfied.

With slack in manpower and productive capacity now reduced to narrow proportions, with the economy closer to full potential than at any time in nearly a decade, and with military demands on output and manpower increasing, it was felt that excessive additions to money and credit availabilities in an effort to hold present levels of interest rates would spill over into further price increases in goods and services. Such price rises would endanger the sustainable nature of the present business expansion. Moreover, increases in costs and prices would make it more difficult for American goods to compete in markets at home and abroad.

In addition, a pattern of interest rates that is accepted by borrowers and lenders as fully reflecting market forces should add assurance of a smooth flow of funds to all sectors of the economy. Discount rate increases in 1963 and 1964 did not stop business or credit growth, but helped to keep the economy within an expansion that was sustainable.

In sum, the actions taken today should have the three-pronged impact of:

1. Backing up the Government's efforts to prevent inflationary excesses from damaging an economy now carrying the added burden of military operations in Vietnam;

2. Bolstering the Government's programs to overcome persistent deficits in the U.S. balance of payments; and

3. Demonstrating anew the United States' determination to maintain the international strength of the dollar.

Governors Robertson, Mitchell, and Maisel dissented from the discount rate action on the ground that it was at least premature in the absence of more compelling evidence of inflationary dangers. Governor Robertson also dissented from the action to increase the maximum rates on time deposits.

[Excerpt from Pratt's Letter, Washington, D.C., Dec. 17, 1965]

DEAR SIR: *There is substantial opinion here* among private and gov't economists, knowledgeable people on Capitol Hill, that the Reserve Board has pulled the biggest boo-boo in the history of the monetary management.

While it was the purpose of the Board to moderate inflationary demands for bank credit, the net effect of the Board's action in increasing CD rates may be to add strong inflationary pressures to the expansion of bank credit. (See LETTER, Dec. 10.)

The amazing part of the whole affair is that only one Board member, Robertson, realized at the time of the action that its effect would be to expand lending at higher rates. Subsequently, Maisel, who voted for the CD changes, pointed out that the change in the discount rate coupled with the change in CD rates "made it possible that the level of credit and demand would be raised rather than lowered * * * and at least initially an undesired increase in real demand could occur."

Invitation to disaster: Some in the Fed still can't believe that commercial banks would get so far out as to offer substantial increases above the old 4½% rate, or that savings institutions would take counter action.

*As reports have come in all week about rate hikes to 5%, 5½% * * ** especially by some smaller national banks . . . chagrin, if not shock, has become evident. Special significance is attached to the fact that those which have gotten the farthest out are largely in the national bank system, where "anything goes" psychology has been nurtured for the past four years.

Only one thing can possibly explain this blind spot on the part of the Fed: Interest rates have been under control for so long money managers have forgot-

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ten how money acts under competitive conditions. Underestimated is the inflationary potential of expanded bank credit when infected with 25 to 1 leverage of time deposits, rather than the 6 to 1 of demand deposits.

Led by the FDIC, the bank supervisors have been exploring since the middle of the week regulatory gimmicks to put controls on the genii. It's not easy to provide a cork for a bad genii and let the good one out.

(U.S. Securities and Exchange Commission Statistical Series Release No. 2117, indicating the volume and composition of individual savings in 1965; and Release No. 2118, indicating drop in corporate holdings of U.S. Government securities and corresponding increase in cash and deposits)

[Release No. 2117, Apr. 14, 1966]

VOLUME AND COMPOSITION OF INDIVIDUALS' SAVING IN 1965

Individuals' saving in financial form [1] amounted to $34 billion in 1965, $2½ billion more than in 1964, according to estimates made public today by the Securities and Exchange Commission. This was the highest total in the postwar period and reflected the continued strong growth in the economy. At the end of 1965 the value of individuals' equity in financial assets, net of liabilities, totaled $1,100 billion, an increase of 8 percent from the previous year-end.

Time deposits at banks and private insurance and pension reserves were the most important forms of individuals' financial savings in 1965 but their ownership of currency and demand deposits also increased significantly. Investment in savings and loan association shares did not show as large a growth as in recent years, reflecting competition from rising rates of return available at commercial banks and from corporate and government bonds. Although strong buying of mutual fund shares continued, individuals were net sellers of other preferred and common stock issues in 1965, as in the preceding seven years. Partly offsetting the record growth in individuals' financial assets was a record increase in their indebtedness; mortgage debt rose almost as much as in the record year 1964, while the gain in consumer credit set a new high.

CURRENCY AND DEPOSITS

Attracted by higher interest rates, individuals' savings accounts at banks expanded by a record $15.2 billion. Saving in currency and demand deposits rose $8.8 billion, $1.8 billion more than the 1964 increase. The growth in savings shares at savings and loan associations and credit unions was $9.2 billion, $2 billion less than in the preceding year.

NET PURCHASES OF SECURITIES

As in 1964, individuals made substantial investments in marketable U.S. Government issues, the yields on which rose sharply during the course of the year. Holdings of U.S. Savings Bonds, Series E and H, rose by $900 million as compared with $1.2 billion during 1964; the lower rate of growth prompted the recent decision to increase interest rates on these issues. With new financing by state and local governments setting a new high in 1965, individuals' ownership of state and local government securities was increased by $2.7 billion, $300 million more than in 1964.

Individuals added $2.1 billion of corporate and other bonds to their investment portfolios in 1965, compared with $900 million in the preceding year. In 1965 a record volume of new corporate debt issues was marketed, including a substantial amount of convertible issues. While financial institutions bought the major part of the increased supply, individuals' acquisitions were greater than in any other year.

Ownership of investment company shares of all types increased by $2.1 billion, approximately the same as in 1964. Net acquisitions of mutual fund shares reached record totals in 1965, but several large transactions involving closed-

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[1] Individuals' financial saving, in addition to personal holdings, covers saving of unincorporated business, trust funds, and nonprofit institutions, and includes saving in the form of securities, currency and bank deposits, saving and loan association and credit union shares, and insurance and pension reserves, net of the increase in individuals' debt.

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end companies had an offsetting effect. Liquidation of other preferred and common stock issues by individuals continued in 1965 as net new stock financing was limited and stock purchases by institutional investors increased sharply.

INSURANCE AND PENSION RESERVES

Equity in private insurance and pension reserves increased more than $13.0 billion, $1½ billion more than the previous record growth in 1964. Private insurance reserves rose $5.4 billion, as compared to a $4.8 billion growth in the preceding year, while insured pension reserves were estimated to have increased by $2.0 billion, the same as 1964. Preliminary estimates indicate that savings in private noninsured pension funds rose $5.6 billion, $700 million more than in 1964. Government insurance and pension reserves increased by $5.0 billion as compared to $4.6 billion the preceding year.

INDIVIDUALS' DEBT

Individuals' indebtedness grew by $23.4 billion during 1965, 5 percent more than in the two preceding years. Despite some slackening in residential construction activity, mortgage debt advanced $15.0 billion, only slightly less than in 1964. Consumer debt on the other hand rose $8.7 billion, $2.2 billion more than in the preceding year. The latter increase primarily reflected the sharp rise in automobile sales. Borrowings on securities declined $300 million over the year.

QUARTERLY TRENDS

Net financial saving during the fourth quarter of 1965 totaled $10.4 billion, $900 million less than the preceding quarter and $400 million lower than the fourth quarter of 1964. Individuals increased their financial assets by $19.2 billion, but their indebtedness rose $8.8 billion, including the usual seasonal growth. The category of saving with the largest increase was currency and demand deposits, reflecting the high level of business activity as well as seasonal pressures.

OWNERSHIP OF FINANCIAL ASSETS

The estimates of financial saving discussed previously and shown in Table 1 do not reflect changes in market values as this series excludes capital gains and losses. In Table 2, however, market values of accumulated financial assets and liabilities at the end of the years 1961–1965 are presented. At the end of 1965, individuals' financial assets totaled $1,397 billion, almost 50 percent higher than five years earlier. Securities holdings comprised 53 percent of the total including common and preferred stock estimated at approximately $550 billion. Other securities held included $50 billion of savings bonds, $32 billion of U.S. government marketable obligations, $38 billion of tax-exempt securities, and $23 billion of corporate and other debt and $46 billion of investment company shares. Insurance and pension reserves totaled over $270 billion, while currency, deposits and savings shares comprised over $385 billion at year-end. Individuals' liabilities totaled $284 billion, comprised of $198 billion of mortage debt, $79 billion of consumer debt and $8 billion of loans for purchasing or carrying securities.

REVISIONS

In addition to the usual revisions to incorporate new and revised source data, a number of changes in concept and form of presentation have been made in the series. The estimates of "gross savings", which have appeared for a number of years in the accompanying Table 1 and which covered individuals' purchases of homes and consumer durable goods as well as their saving in financial form, have been discontinued. Annual figures on individuals' investment in nonfarm homes and other tangible assets are included in the table comparing saving estimates of the SEC with the personal saving estimates of the Department of Commerce (see "Other concepts of saving" below), and it is planned that eventually quarterly comparisons, seasonally adjusted at annual rates, will be prepared.

Among the more important conceptual revisions in the series on net financial saving is a change in life insurance saving of individuals. Formerly, profits of stock life insurance companies were credited to individuals but now are treated as business saving. This is consistent with treatment given such profits in the National Income Accounts. Also excluded from the revised series are changes

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in unemployment and social security funds on the basis that they primarily are transfer payments. Revised quarterly figures for the postwar years are being prepared and will be available for distribution in July.

OTHER CONCEPTS OF SAVING

There are other concepts of individuals' saving with different degrees of coverage currently in use. The personal saving estimate of the Department of Commerce is derived as the difference between personal income (after taxes) and expenditures. The Federal Reserve Board's flow-of-funds system of accounts includes estimates of gross saving and net financial investment of households. A comparison of the Securities and Exchange Commission estimates and the Department of Commerce series will appear in the July *Survey of Current Business* and the Commission's *Statistical Bulletin*.

TABLE 1.—*Saving by individuals in the United States*[1] *1963–65*

[In billions of dollars]

Type of saving	1963	1964	1965	1964, October to December	1965			
					January to March	April to June	July to September	October to December
1. Currency and demand deposits	6.8	7.0	8.8	4.9	−2.7	1.9	3.8	5.9
2. Time and saving deposits	11.6	12.3	15.2	3.2	4.6	3.1	4.2	3.2
3. Savings shares [2]	11.7	11.3	9.2	3.5	2.1	2.5	1.4	3.3
4. Securities	1.6	7.0	6.3	1.4	1.4	1.9	1.2	1.8
(a) U.S. savings bonds:								
(1) Series E and H	1.6	1.2	.9	.3	.3	.2	.1	.3
(2) Other	−.4	−.3	−.2	−.1	−.1	−.1	−.1	(3)
(b) Other U.S. Government [3] [4]	.7	3.3	3.1	.3	1.0	.3	.9	.9
(c) State and local government	1.8	2.4	2.7	.4	−.1	.9	.5	1.4
(d) Corporate and other	−2.1	.4	−.1	.3	.2	.6	−.3	−.7
(1) Bonds and notes	.5	.9	2.1	.8	.3	1.2	.6	(3)
(2) Investment company shares [5]	1.6	2.0	2.1	.9	.1	.7	.7	.6
(3) Other preferred and common stock	−4.3	−2.5	−4.3	−1.4	−.2	−1.2	−1.5	−1.3
5. Private insurance and pension reserves	10.7	11.7	13.1	3.5	3.1	2.8	3.3	3.9
(a) Insurance reserves	4.5	4.8	5.4	1.6	1.2	1.1	1.4	1.7
(b) Insured pension reserves [6]	1.7	2.0	2.0	.5	.5	.5	.5	.5
(c) Noninsured pension reserves	4.5	4.9	5.6	1.4	1.4	1.3	1.3	1.7
6. Government insurance and pension reserves [7]	4.0	4.6	5.0	1.3	1.1	1.3	1.3	1.3
7. Increase in debt (8+9+10)	22.1	22.2	23.4	6.8	3.2	7.5	3.9	8.8
8. Mortgage debt [8]	14.9	15.6	15.0	4.1	3.7	3.3	3.5	4.4
9. Consumer debt [9]	6.3	6.5	8.7	3.0	−.4	3.4	2.3	3.3
10. Securities loans [10]	.9	.1	−.3	−.3	−.1	.7	−2.0	1.1
11. Net financial saving (1+2+3+4+5+6−7)	24.3	31.7	34.1	10.8	6.2	6.1	11.3	10.4

[1] Includes unincorporated business saving of the types specified. Figures are rounded and will not necessarily add to totals. The foregoing data have been compiled by the Commission from many different sources. Because of the nature of the figures, current data are necessarily estimates, and, therefore are subject to revision.

[2] Includes shares in savings and loan associations and shares and deposits in credit unions.

[3] Indicates less than $50,000,000.

[4] Includes nonguaranteed Federal agency securities.

[5] Includes closed-end investment companies as well as mutual funds.

[6] In addition to corporate funds, includes reserves of nonprofit organization and multiemployer plans.

[7] Includes civil service, railroad retirement and state and local retirement funds.

[8] Mortgage debt to institutions on 1-to-4-family nonfarm dwellings.

[9] Consumer debt owed to corporations, largely attributable to purchase of automobiles and other durable consumer goods, although including some debt arising from purchases of consumption goods. Policy loans on government and private life insurance have been deducted from those items of saving.

[10] Change in bank loans to brokers and dealers and others made for the purpose of purchasing or carrying securities.

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TABLE 2.—*Financial assets and liabilities of individuals in the United States, yearend 1961–65*

[In billions of dollars]

	1961	1962	1963	1964	1965
Financial assets:					
1. Currency and demand deposits	80.0	82.8	89.6	96.6	105.4
2. Time and saving deposits	109.7	124.6	136.2	148.6	163.7
3. Savings shares	75.7	85.6	97.3	108.6	117.9
4. Securities	593.2	538.1	617.7	685.7	739.1
(a) U.S. savings bonds	46.4	46.9	48.0	49.0	49.6
(b) Other U.S. Government [1]	26.7	27.8	28.4	30.2	32.3
(c) State and local government	30.8	31.1	32.9	35.3	38.0
(d) Corporate and other [1]	489.3	432.3	508.3	571.3	619.2
(1) Bonds and notes	20.9	21.4	21.5	22.4	23.3
(2) Investment company shares	32.6	30.1	34.8	39.8	46.3
(3) Other preferred and common stock	435.8	380.8	452.0	509.1	549.6
5. Private insurance and pension reserves	156.8	164.0	178.2	193.7	208.7
(a) Insurance reserves	91.3	95.6	100.2	105.1	110.6
(b) Insured pension reserves	20.2	21.6	23.3	25.2	27.2
(c) Noninsured pension reserves	45.3	46.7	54.6	63.4	70.9
6. Government insurance and pension reserves	44.5	48.3	52.3	56.8	61.8
7. Total financial assets (1 through 6)	1,060.0	1,043.3	1,171.2	1,290.0	1,396.5
Liabilities:					
8. Mortgage debt	139.9	152.4	167.3	182.8	197.9
9. Consumer debt	52.0	57.0	63.3	69.8	78.5
10. Securities loans	6.1	7.2	8.1	8.2	7.9
11. Total liabilities (8+9+10)	198.0	216.6	238.7	260.8	284.3
Total individuals' net equity [2] (7–11)	862.0	826.7	932.4	1,029.3	1,112.3

[1] Estimated market value. Nonguaranteed Federal agency issues are included with U.S. Government issues.

[2] The year-to-year changes in the above data are not equivalent to individuals' saving which does not reflect revaluations in certain of the components.

[Release No. 2118, Apr. 15, 1966]

WORKING CAPITAL OF U.S. CORPORATIONS, DECEMBER 31, 1965

The net working capital of U.S. corporations, excluding banks and insurance companies, rose $2.6 billion in the fourth quarter of 1965 according to estimates made public by the Securities and Exchange Commission. Working capital, which represents business investment in current assets in excess of short-term liabilities, totaled $171.7 billion at the end of December, an increase of $10.6 billion for the year 1965.

CHANGES IN CURRENT ASSETS AND LIABILITIES IN 1965

The increase in current assets amounted to $34.8 billion in 1965 and was offset partly by a $24.2 billion rise in current liabilities. Trade notes and accounts receivable rose a record $19.7 billion during the year and inventories were increased $12.3 billion. Among the more liquid items, cash and deposits rose $2.1 billion during the 12 months ending in December but there was an equivalent drop in holdings of U.S. Government securities. The ratio of these two items to total current liabilities—a rough measure of corporate liquidity—amounted to 27 percent at the end of December compared with 30 percent a year earlier. "Other current assets"—consisting principally of short-term marketable investments (other than U.S. Government securities and negotiable time certificates of deposit), prepaid items and deferred charges—rose $2.8 billion during the year.

On the liabilities side, notes and accounts payable rose $17.8 billion in 1965 reflecting sharp increases in short-term bank borrowing as well as increases in payables arising from ordinary business transactions. Federal income tax liabilities rose $2.0 billion between December 1964 and the end of 1965. "Other current liabilities" also showed a substantial increase during the year, $4.4 billion.

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Manufacturing corporations accounted for $6.2 billion of the increase in working capital in 1965. Trade and finance groups reported gains of more than $2 billion while utilities showed a decline in net working capital during the year.

QUARTERLY CHANGES IN WORKING CAPITAL

The fourth quarter gain of $2.6 billion in net working capital compares with increases of $2.9 billion in the preceding quarter and $1.7 billion in the fourth quarter of 1964. The advance in corporate working capital in the fourth quarter was associated with substantially larger increases in current assets and liabilities than occurred in prior quarterly periods. Increases on the assets side occurred in all items except "other current assets" which normally shows a decline in the fourth quarter. Cash and Government securities together rose $4.5 billion, inventories increased $3.2 billion and trade notes and accounts receivable rose $4.9 billion.

Among the liability items, notes and accounts payable increased $7.2 billion, federal income tax liabilities rose $2.0 billion and "other current liabilities" increased $600 million.

Trade and finance companies accounted for most of the increase in net working capital in the fourth quarter. Manufacturing and transportation firms reported smaller increases while utility and communication firms had a drop in working capital in the October-December period.

OTHER INVESTMENTS AND SOURCES OF FINANCING

In addition to the $10.6 billion increase in net working capital in 1965, corporations invested approximately $46 billion for plant and equipment in the United States and more than $10 billion in other assets, including residential structures and fixed assets of foreign subsidiaries. Corporations obtained about four-fifths of the funds needed to finance this record expansion, through internal funds—depreciation and retained earnings. About $8 billion was obtained through net new securities flotations, primarily debt issues, and long-term bank and mortgage financing provided the balance of funds.

The accompanying table gives the aggregate estimates of current assets and current liabilities of U.S. corporations.

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Current assets and liabilities of U.S. corporations[1]

[In billions of dollars]

	1962—Dec. 31	1963—Dec. 31	1964				1965			
			Mar. 31	June 30	Sept. 30	Dec. 31	Mar. 31	June 30	Sept. 30	Dec. 31
Current assets:										
Cash on hand and in banks	42.9	44.5	40.6	42.5	43.1	45.0	42.5	43.7	43.6	47.1
U.S. Government securities	20.2	20.6	21.4	20.2	19.1	19.1	18.5	16.3	16.0	17.0
Receivables from U.S. Government[2]	3.7	3.6	3.3	3.0	3.2	3.4	3.3	3.2	3.6	3.9
Notes and accounts receivable	146.7	159.7	161.3	165.6	171.6	173.8	177.5	182.8	188.3	198.0
Inventories	100.9	107.3	108.6	109.6	111.2	114.3	117.3	119.7	123.4	126.6
Other current assets[3]	12.4	14.3	15.5	15.9	16.1	15.5	17.2	18.4	18.6	18.3
Total, current assets	326.7	349.9	350.6	356.7	364.3	371.0	376.4	384.3	393.5	405.8
Current liabilities:										
Advance and prepayments, U.S. Government[2]	2.0	2.5	2.6	2.6	2.7	2.7	2.8	2.9	3.1	3.1
Notes and accounts payable	121.2	131.8	128.9	131.7	135.0	140.0	141.4	145.9	150.2	157.4
Federal income tax liabilities	15.0	16.3	15.6	15.2	16.0	17.0	16.6	15.9	17.0	19.0
Other current liabilities	45.7	48.2	48.8	50.1	51.2	50.2	52.1	53.2	54.1	54.6
Total, current liabilities	184.0	198.8	195.9	199.6	204.9	209.9	212.9	218.0	224.4	234.1
Net working capital	142.8	151.2	154.7	157.1	159.4	161.1	163.5	166.2	169.1	171.7

[1] All U.S. corporations excluding banks, savings and loan associations, and insurance companies. Year-end data for this series through 1961 are based on statistics of income, covering virtually all corporations in the United States. Statistics of income data may not be strictly comparable from year to year because of changes in the tax laws, basis for filing returns, and processing the data for compilation purposes. All interim quarterly data and all year-end estimates after 1961 are based on data compiled from many different sources, including data on corporations registered with this Commission.

[2] Receivables from and payable to U.S. Government do not include amounts offset against each other on corporations' books or amounts arising from subcontracting which are not directly due from or to the U.S. Government. Wherever possible, adjustments have been made to include U.S. Government advances offset against inventories on corporations' books.

[3] Includes marketable securities other than U.S. Government.

NOTE.—Figures are rounded and will not necessarily add to totals.

LEGISLATIVE HISTORY OF PROVISION OF BANKING ACT OF 1933 PROHIBITING PAYMENT OF INTEREST BY BANKS ON DEMAND DEPOSITS (48 STAT. 162, 181–182 § 11(B)): 12 U.S.C. 371(A)

JANUARY 26, 1966.

Disclosure of the purposes to be subserved by enactment of the aforementioned provision is contained only in the debates in the Senate on S. 1631 during the first session of the Seventy-Third Congress. After approval of this measure the Senate proceeded to amend the companion House Bill, H.R. 5661, by striking out everything after the enacting clause and substituting the terms of S. 1631. As thus amended, H.R. 5661 was approved by the Senate, and thereafter both Houses accepted the Conference Report on the latter measure. No provision comparable to the one finally enacted was included in H.R. 5661 § 10(b) as originally introduced and approved by the House; and no consideration of this provision is to be found in the House and Senate Committee reports published in connection with the debates on the aforementioned bills.

Almost at the very outset of the debate on S. 1631 Senator Carter Glass offered the following explanation of the objective to be fostered by inclusion of a ban against the payment of interest on time deposits.

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"The payment of interest on demand deposits has resulted for years and years in stripping the country banks of all their spare funds, which have been sent to the money centers for stock speculative purposes. When we adopted the Federal Reserve Act and rescued the reserve funds or trust funds of the national banking system from the stock gamblers we had hoped that that would be a salutary lesson to all member banks of the system. We had hoped that they would be impressed by the fact that they were no longer in involuntary servitude to their correspondent banks and that they would deal with the regional reserve banks rather than with banks in the money centers. But we have been disappointed in that respect. Bankers all over the country in every State I venture to say—I speak definitely of my own State—have what they call a 'standard rate of interest', which is the limit of the law in the respective States; and they never depart from it, except in special cases and for large purposes. In other words, if the standard rate is 6 percent, as it is in Virginia, one never finds a bank in days of prosperity and one never finds a member bank of the system that ever lends the merchant or the manufacturer or an industry of any kind or the farmer at a less than 6-percent discount rate. They give the foolish reason for that, that if they ever once depart from the standard rate they cannot get back. Well, they can get back, and they can get back for exactly the same reason which induced them to depart. If they have abundant funds and credits they can lower the rate of interest in order to stimulate business and industry and farming activities.

"If the demand is great and money is tight, they can go back to their standard rate just for the same reason or a like reason that actuated them in departing from it. But they do not do that. Bankers are the only people on earth that utterly disregard the law of supply and demand. They have their standard rates and stick to them, and would rather send their surplus funds to New York to be used for stock-gambling purposes at a wonderful rate of 2 percent, reduced now, I think to 1½ percent, than to loan to their merchants and business men at less than their standard rates. So that this payment of interest, particularly on bank-demand deposits, has resulted in drawing the funds from the country banks to the money centers for speculative purposes, to be polite about the matter. . . .

"We confide to the Federal Reserve Board authority which it does not now possess in this connection to regulate interest on time deposits in order to put a stop to the competition between banks in payment of interest, which frequently induces banks to pay excessive interest on time deposits and has many times over again brought banks into serious trouble. But that is a matter purely for regulation of the Federal Reserve Board. . . .

"The payment of interest on demand deposits, a system viciously and partially administered, particularly in the great money centers of the country, had resulted in withdrawing from the interior country banks of the United States millions upon millions of dollars to the money centers, to be cast into the maelstrom of stock gambling, and we wanted to put a stop to that.

". . . It was ascertained that over a period of 6 years last past the average interest paid on demand deposits by banks of the Federal Reserve System alone aggregated $230,000,000, and in 1929 that interest amounted to $259,000,000. So that it was a magnet for all the surplus funds of every country bank in the United States, to draw these funds to the money centers for speculative purposes . . .

"The banks of the country almost universally are protesting against the assessment of one half of 1 percent upon their time and demand deposits as a contribution to the capital fund set up to insure bank deposits. If the banks are relieved of the competitive necessity of bidding for demand deposits on interest, they will not only have money to meet this assessment of one half of 1 percent to insure deposits, but they will have almost an equal amount left over. I have no doubt in the world that a vast majority of the commercial banks of the country will be glad to be prohibited by law from engaging in this competition of interest on demand deposits." (77 Cong. Rec. 3729, 4165–4166, 4169 (1933)).

Also enlightening was the following comment of Senator Connally of Texas. "The payment of interest on time deposits by banks has become a racket. If

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you have a thousand dollars or $2000 or a small account in a commercial bank, you do not get any interest on it. Take the case of some industrial concern with a large deposit, however, and what happens? Every bank in turn is bidding to get that deposit, and the payment of interest on it is a form of rebate, a form of preference by which the banks accumulate these large deposits, and the ordinary depositor of the bank is bearing the burden. They are operating on his money and are paying preferential interest to industrial concerns and business concerns whose business they want to obtain. . . .

". . . A lot of big banks are against this [this provision]. Why? Because they want to be in a position to bid for the country banker's deposits, and in order to do that they want the power to pay interest. . . ." (77 Cong. Rec. 4169 (1933)).

SOURCES:

H. Rept. no. 584; 72d Cong., 1st Sess. (1932); H. Rept. nos 150, 254; 73d Cong, 1st Sess. (1933); S. Rept. no. 77; 73d Cong., 1st Sess. (1933).

Senate Committee on Banking and Currency. Hearings on Operation of the National and Federal Reserve Banking Systems.

71st Cong., 3d Sess. pts. 1–7. January 19–30, 1931.

77 Cong. Rec. 3725–3731, 3740, 3834–3842, 3933, 4058, 4161–4182, 4399, 5769, 5861–5863, 5928 (1933).

* * *

LEGISLATIVE HISTORY OF 12 CFR 217.1 (e) (1), 217.135 WHEREBY BANKS WHICH ARE MEMBERS OF THE FEDERAL RESERVE SYSTEM ARE PRECLUDED FROM ACCEPTING SAVINGS DEPOSITS TENDERED BY COMMERCIAL CORPORATIONS OPERATING FOR PROFIT.

APRIL 4, 1966.

The authority of the Federal Reserve Board to issue these cited regulations is derived from 12 U.S.C. 461 which was first enacted as § 324(a) of the Banking Act of 1935 (49 Stat. 684, 714). By the terms of 12 U.S.C. 461 the Board of Governors of the Federal Reserve System is empowered to define such terms as "savings deposits". Set forth in Title 3 of the measure adopted as the Banking Act of 1935, which was described as containing a compendium of non-controversial, technical amendments of the Banking Laws, § 324(a) was accorded no consideration either in committee reports or in the debates which preceded passage of that Act. Affording a partial explanation of the reasons which prompted passage of § 324(a) are the following excerpts from committee hearings and from the Bulletin published by the Federal Reserve Board.

"We found great difficulty in applying the definitions that were in the [1933] act, and we found some of the banks attempting to circumscribe the prohibitions [against interest on demand deposits]; and we wanted, when we found the evasions, to keep correcting the definition until they could not evade it" (J. F. T. O'Connor, Comptroller of the Currency. U.S. Cong. Senate, Committee on Banking and Currency Hearings on Banking Act of 1935; S. 1715 and H.R. 7617; 74th Cong., 1st Sess., April 19–June 3, 1935, p. 168).

"I think we must sooner or later make a distinction between a savings deposit, which is for the small man, carefully protecting and restricting savings deposits, and those large time deposits that go to such big figures" (Professor Edwin S. Kemmerer. Hearings, op. cit., p. 343).

Basis of Provision in Regulation That Business Corporations May Not Maintain Savings Deposits—"The Banking Act of 1935 conferred upon the Board authority to define the term 'savings deposits' and to prescribe such rules and regulations as it may deem necessary to effectuate the purposes of the law and prevent evasions thereof. This authority was granted in order to enable the Board to correct certain well-recognized abuses which had grown up in connection with savings deposits.

"Member banks are forbidden by law to pay interest on demand deposits or to pay time deposits before maturity except in certain exceptional circumstances. However, they are permitted to pay savings deposits on demand, provided they reserve the right to require 30 days' notice of withdrawal, and they are also permitted to pay interest on such deposits. In addition, member banks are permitted to carry with Federal Reserve banks a reserve of only 3 percent against savings deposits, although they are required to carry reserves of 7, 10, or 13 percent, depending upon the location of the respective banks, against all other

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deposits which are payable upon demand. Savings deposits, therefore, are the only class of deposits payable on demand upon which member banks are permitted to pay interest and to maintain reserves of only 3 percent.

"These privileges were accorded with respect to savings deposits because of the desire to encourage thrift; but they led to certain abuses, chief of which were the classification of ordinary demand deposits as savings deposits in order to pay interest on such funds and to carry the lower reserves against them, and the classification of idle funds of business corporations as savings deposits even though such funds were not accumulated for genuine thrift purposes.

"It is believed that 'savings deposits,' in the true meaning of the term, are deposits which consist of the accumulations of savings of individuals, usually of limited financial means, in order to provide for sickness, accident, old age or other exigencies, to meet anticipated expenses, or for other similar purposes. Although there are certain nonprofit organizations which may properly be included in the class of those who are entitled to the privilege of maintaining savings deposits, it is not believed that corporations operated for profit fall within this category. Accordingly, in section 1(e) of Regulation Q, the Board has provided that a savings deposit must consist of the funds of one or more individuals or of an organization operated primarily for religious, philanthropic, charitable, educational, fraternal or other similar purposes and not operated for profit.

"The Board also called attention to the fact that, although Regulation Q does not permit deposits of a business corporation to be classified as savings deposits, there is nothing to prevent a business corporation from placing its funds in an interest bearing time deposit" (22 Federal Reserve Bull. 191–192 (1936)).

Significance of the 1966 Business Outlook for the Savings and Loan Industry

(An address by Dr. Gordon W. McKinley, Vice President-Economics, McGraw-Hill, Inc., at the Annual Meeting of the Federal Home Loan Bank of New York, in the Grand Ballroom of the Waldorf-Astoria, New York City, on April 13, 1966.)

Uppermost in the minds of savings and loan executives today are such problems as the competition for savings, the growing squeeze in the credit markets, the threat of a tax increase, and the uncertain prospect for housing, for mortgages, and for mortgage loan rates. I want to devote a good portion of my talk this morning to these matters, but before we can reach conclusions about any of them we must first have in mind a pretty clear picture of the likely course of business activity and particularly the degree of pressure which business activity will exert on our resources of labor and capital.

Even at the beginning of 1966 there were signs that the economy was reaching full employment. Unemployment had dropped to 4 per cent of the labor force, most industries were operating close to maximum efficient utilization of available plant, order backlogs were rising, and shortages were beginning to appear. Since the beginning of the year, output has risen so rapidly that strains and stresses are becoming more apparent and more severe. The unemployment rate has declined to the lowest point in over 12 years, labor unions are becoming increasingly restive and openly flouting the Administration guidelines, and wholesale prices are rising at an annual rate of 5 per cent.

Many factors are contributing to these strains but the single overriding force, outweighing all others and affecting every segment of the economy, is the great upsurge in government spending. It is the more striking because it follows on an extended period of comparative stability in government expenditures. At the beginning of 1965, total purchases of goods and services by the Federal Government were running at an annual rate of just over $64 billion. This $64 billion rate of government purchases was no higher than it had been two and a half years before, in the middle of 1962. In fact, government purchases had been declining in late 1964 and the budget presented at the beginning of 1965 had envisioned a further minor decline.

The escalation of the war in Vietnam plus the extraordinary scope of the Great Society legislation enacted in the first half of 1965 very soon put an end

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to the stability of government spending. The rate of Federal Government purchases rose by $1 billion in the first half of 1965, jumped another $1 billion in the third quarter, and then soared an additional $3 billion in the fourth quarter. This rapid rise in federal spending is continuing and will continue throughout 1966. It now seems likely that the annual rate of federal purchases, which had risen to over $69 billion in the closing quarter of 1965, will reach $78 billion in the closing quarter of this year, a huge increase of $9 billion in Federal demand for the output of the economy.

State and local government spending will also rise rapidly this year, partly because of the steady increase in all the regular services such as schools, and police, and roads, which are provided by these governments, and partly because the expenditures under many Great Society programs are made by the state and local governments even though a good portion of the funds may come in the form of grants-in-aid from the Federal Government. The rate of state and local government purchases is likely to rise by $7 billion between the fourth quarter of 1965 and the fourth quarter of 1966.

Total government purchases (by federal, state, and local units) thus appear headed for an increase this year of $16 billion. It would be difficult to exaggerate the tremendous impact of this outpouring of expenditures. The impact is not confined to the industries and areas where the expenditures are initially made. The resulting rise in employment and incomes transmits the impact to other industries and other areas in spreading ripples or waves throughout the economy. Nor is the impact confined to direct dollar expenditures. The prospect of so large a rise in government spending has considerably changed consumer and business expectations and this change in expectations has led to a whole new set of decisions to spend and invest.

One area of the private economy where expectations have a marked effect is business inventory policy. Were it not for the strong rise in government spending, business inventory policy at present would probably be very conservative. Steel users who built up excess inventories over the first 8 months of 1965 for fear of a strike would be cutting steel orders sharply in order to get stocks back into line. Auto companies and auto dealers would be less happy with the current high volume of cars on hand. With little fear of shortages or price rises, most businesses would try to keep inventory shelves as bare as possible.

The actual situation facing us today, however, is quite different. Expectations of future sales volume are high and the fear of shortages and price rises is growing. Instead of cutting inventories, businessmen are likely to continue to build inventories throughout 1966 at a pace almost as rapid as in 1965.

A second segment of the private economy which will be strong in 1966 is business expenditures on plant and equipment. Business capital spending has soared during the past 5 years, climbing from a $46 billion rate at the bottom of the 1961 recession to $73 billion at the end of 1965. During this period, a total of almost $285 billion was devoted to expansion and modernization of our productive facilities!

Despite this huge investment in new facilities, sales and output have climbed even more rapidly than capacity. Even though more and more plants are coming on stream, percentage utilization of capacity has increased, with most industries during the past year operating very close to their preferred maximum utilization rate.

There is no question that capital investment will climb still higher in 1966. Orders for new machinery and equipment are at record levels and the backlog of unfilled orders is mounting. Construction contracts are strong. Unexpended capital appropriations are higher than at any previous time in our history. Finally, businessmen themselves, in responding to the latest survey of their investment plans, have indicated that they now have plans for expenditures on plant and equipment 16 percent higher than even the huge 1965 total.

It is probable that business expenditures on plant and equipment will rise throughout the year, reaching a $81 billion annual rate in the final quarter. This would mean that business capital spending for the full year 1966 would total about $9 billion more than in 1965.

Despite the boom of the past two years there has been one segment of the economy—residential construction—which has been notable principally because of its failure to participate in the general upward rush. Residential construction in the United States reached a peak rate in late 1963 and early 1964, and

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thereafter declined steadily and quite sharply all through 1964 and into early 1965. Private nonfarm housing starts fell from a rate of over 1,700,000 at the beginning of 1964 to a rate under 1,500,000 in early 1965. Throughout last year the volume of starts continued close to this reduced level with no sign of a further decline but also with little indication of a real revival.

In considering the outlook for housing, it is well to bear in mind two basic facts: (1) The entire decline in the national housing start figure from the beginning of 1964 to the end of 1965 was accounted for by the very sharp slump in housing on the West Coast. Housing output in the rest of the United States remained virtually level during those two years. (2) The *effective demand* for housing during the past year has been greater than the output of housing. In other words, we have been gradually absorbing an excess inventory of homes and apartment units which had been built up in late 1963 and early 1964.

With these two facts in mind it is clear that with the passage of time a revival in the housing market becomes more and more likely. We have greatly reduced the excess inventory of homes and apartments. Vacancy rates have fallen and new homes for sale have declined. Although the situation is still not good on the West Coast, it is much improved and the rise in defense expenditures will particularly help that geographic area. Employment and incomes throughout nation are high, and marriage rates are rising.

Ordinarily, these buoyant forces might be expected to produce an upsurge in residential construction in 1966, and in fact such an upsurge would have occurred had it not been for the extremely tight situation which has developed in the capital markets. As you well know, this tightness has fallen with particularly severity on housing and will continue to do so throughout the rest of the year.

We are already witnessing the squeeze on residential construction, with February's housing start rate for the U.S. as a whole dropping to the lowest level in 5 years. In the Second Federal Home Loan Bank District, housing starts were off 10 per cent in the first two months of this year from the level in early 1965. Despite the strength in the basic demand for housing, tight money is likely to prevent an appreciable rise in housing output over the rest of this year. My guess is that housing starts in this District as well as in the rest of the country will be about the same as in 1965. Residential construction expenditures for the U.S. as a whole will be up by less than half a billion dollars.

What I have said about housing does not, however, apply to other consumer expenditures. Ever since the big tax cut of 1964 consumers have seemed bent on establishing the fact once and for all that if government permits them to retain a larger portion of their incomes they will see to it that this extra money does not lie idle. Retail sales have boomed and the automobile industry has enjoyed year after year of successive records.

In 1966, consumer purchases are continuing to soar. Retail sales thus far this year are 8 per cent ahead of 1965. The huge increase in government spending coupled with the large rise in business capital spending is forcing up employment and incomes. Consumer confidence and expectations are high and their appetite for more and more goods and services seems insatiable. The exceptional size of the teen-age group in recent years has added a particular stimulant to retail sales, and now that these big teen-age groups are reaching working age the spending will be intensified. All of these factors working together *could* produce a spending psychology in the months ahead so explosive as to result in a wild spending spree similar to that which erupted following the outbreak of the Korean War in late 1950.

There are, however, a number of constraints which may exert sufficient force to avert so extreme a situation. *First*, the social security tax rate payable by employers and employees rose quite sharply at the beginning of this year and this increased tax is biting deeply into consumers' take-home pay. *Second*, a bill has just cleared Congress which rescinds for a year the excise tax cut on autos and telephone service and also provides for a graduated scale of personal income tax withholding rates. *Third*, consumers enter the year 1966 with large debts and a heavy schedule of debt repayment. Consumer credit outstanding rose $5.5 billion in 1962, $6.7 billion in 1963, $7.0 billion in 1964, and over $9 billion in 1965. These are rather disconcerting figures. One cannot take consolation in the fact that there are more consumers and higher incomes; the fact is that the rise in consumer debt has far outstripped the increase in after-tax income. Repayments on installment credit alone now require 14.5 per cent of

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total consumer incomes after taxes. This does not include payments due on noninstallment debt, nor payments on mortgage debt.

While the heavy indebtedness of consumers places the economy in a vulnerable position in the event of some future recession, this indebtedness is a favorable factor when viewed against the potentially inflationary situation in the year ahead. We are fortunate that large installment payments will act with higher taxes to curb consumer buying. Because of these constraints, the rise in consumer spending is likely to be held to $31 billion. This is a tremendous increase but no more than occurred in the previous year.

Now what does all this mean for the economy as a whole? I have pointed out that federal, state and local government spending is likely to rise by about $16 billion in 1966. Under pressure of this tremendous flood of government expenditures most private sectors of the economy will inevitably be pushed upward. Business capital expenditures will rise by about $9 billion. Business inventory purchases will continue strong. Expenditures on residential construction will show only a minor gain, but consumer spending will leap ahead by about $31 billion despite the already high level of installment debt and despite the recent increase in taxes. This torrent of government and private spending will mean that gross national product will rocket upward to $730 billion in 1966, an increase of $54 billion or 8 per cent above the figure for 1965.

In most years, so rapid a growth in national output would be a prospect which could be welcomed unreservedly. But in 1966 we have already bumped up against the practical ceiling imposed by our available resources of labor and capital. In the months ahead, the growth in our *real* output cannot exceed that made possible by the slow growth in the labor force and the modest improvement in productivity. As nearly as I can estimate these factors, the apparent maximum increase in our real output this year will be 4.5 per cent.

When the prospective rise of 8 per cent in dollar expenditures is set off against the probable limit of a 4.5 per cent increase in real goods and services, it is clear that the danger of inflation is both real and imminent. There is no question that the economy will be prosperous this year, with GNP accomplishing the largest absolute increase in our history. There is also no question that, unless the Administration takes further steps to cut government spending or increases taxes, we will experience the most serious inflation since 1956–57.

Against this background of inflationary boom, let's consider the following four questions, each of which has an obvious bearing on your business: First, what is the likelihood of an increase in income tax rates later this year?

Second, what course is Federal Reserve credit policy likely to take and what will happen to interest rates in the months ahead? Third, is the interest rate ceiling on commercial bank time and savings deposits likely to be raised further? Fourth, what are the growth prospects for the savings and loan industry in 1966 and the years beyond?

During the past several weeks top officials of the Johnson Administration have begun to speak more and more as though an increase in income tax rates is under serious consideration. I do not pretend to know whether such an increase will occur, but there are good reasons for concluding that the odds are still about 2–1 *against* such an increase. There is now little doubt that the budget presented in January was not sufficiently restrictive—taxes should have been raised more decisively or non-defense spending should have been cut further. But even if this is generally recognized within government, there are still a number of courses other than a tax increase open to the Administration. *First*, non-defense spending can be cut. It is simply not realistic to assume that it is impossible to defer any of the public works included in the federal budget. If the President can appeal to businessmen to cut their capital projects and can speak approvingly of deferrals of state roadbuilding projects, as he has done, then it is not unreasonable to ask for deferrals of Federal public works. *Second*, the President can take numerous actions to lessen price increases, by releasing stockpiled materials, by temporary relaxation of import barriers, and by appeals for moderation in private wage and price policy. *Third*, the Administration can accept such inflation as occurs in the hope that the worst pressure will be over by the end of 1966.

I am not attempting to evaluate the wisdom of these alternatives; I am simply pointing out that there are alternatives to a tax increase. My guess is that these will be the alternatives which will be chosen, and taxes will not be raised further in 1966.

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Fortunately, the situation facing us today is not as serious as would have been the case had monetary policy not been used so effectively. All of you well remember the violent protests from some quarters last December when the Federal Reserve raised the discount rate. We were told that the move was not only unnecessary but positively harmful. It was said that the fear of inflation was imaginary and that credit restraint would precipitate a recession. The Federal Reserve was accused of not coordinating its policies with Administration budget plans, and demands for a curb on the independence of the Federal Reserve Board were renewed.

Only four months have passed, yet the action of the Federal Reserve in tightening credit has been fully vindicated. The economy has reached full employment and prices are rising. The critics of the Federal Reserve have turned out to be exceedingly poor business forecasters. We are fortunate indeed that the Reserve Board had both the independence and the good judgment to take effective action in time to avert even worse inflationary pressures. If coordination of monetary and fiscal policy was needed, it is beginning to look as though Administration budget plans should have been coordinated with Federal Reserve policy, rather than vice versa.

In the months ahead, monetary policy will continue tight. I believe that the recent rise in bond prices is temporary. The capital markets will feel renewed pressure as corporate income taxes are accelerated. In addition, a number of Government Agencies are planning offerings designed to shift assets to private holders. The probability is that capital market rates will move up again during the remainder of the year, rising by 15 to 25 basis points from the current level.

* * * It seems to me that the Federal Reserve has made a serious mistake over the past several years in repeatedly raising the interest rate ceiling on commercial bank time and savings deposits to the present very high limit. The arguments advanced in support of these increases—particularly the increase of December, 1965—strike me as weak and even illogical. It does not seem consistent to act to restrain credit with one hand and to increase the flow of deposits into the commercial banking system with the other. The result has been to place competing savings institutions at a serious disadvantage, to bear down with unequal pressure on the housing market, and to set in motion a wasteful and possibly dangerous scramble for deposits. It is not reassuring to have it explained that a rise in the rate ceiling was necessary in order to avert a money market crisis. Nor is it sensible to raise the ceiling and then criticize bankers for going to the ceiling. Both the theory and the practice of Regulation Q are in need of some serious rethinking. It is to be hoped that the rethinking occurs before a point of no return is reached. In view of the illiquid position to which the rise in Regulation Q has brought the banking system I cannot believe that a further rise in the ceiling will be permitted.

Let me conclude with a brief comment on the growth prospects for the savings and loan industry in 1966 and the years beyond. During the remainder of this year, continued tight money and a severe competitive situation is likely to hold the industry to a relatively small increase in savings. But the outlook in subsequent years is excellent.

To begin with, the whole structure of interest rates is likely to reach a cyclical peak in 1966, with interest rates in four out of the next five years being lower than in 1966. A less tight situation will prove advantageous to the savings and loan industry in at least two ways: *First*, mortgage loan rates, which have moved up less than other rates, will in the future decline less than other rates. This opens up the possibility of a better relationship between rates which savings and loan associations earn on mortgages and rates which they must pay on savings. *Second*, a somewhat lower general interest rate structure will remove some of the pressure which has forced commercial banks to go to extremes in interest rates payable on time and savings deposits. I believe the result will be beneficial to both savings and loan associations and commercial banks.

The savings and loan industry will also gain in the years ahead from a resurgence in residential construction. The number of marriages in the United States has risen substantially during the past two years and marriages will continue to rise at an unusually rapid rate during the decade ahead. Even if the fertility rate continues at the current low figure, the growing number of marriages will soon be reflected in a growing number of children. The inevitable

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result will be an upward jump in the demand for more and bigger housing, an increase which will carry housing starts to the 2,000,000 annual figure by 1970.

The savings and loan industry during the past five years has experienced a number of difficult problems. The industry has done a good job of meeting these problems and, with a few individual exceptions, emerges from this period of testing a more mature and better managed group of associations. Bearing in mind the lessons of the past, your industry is now better prepared than ever to look forward to a sound and prosperous future.

Some Reflections on Interest Rates and Their Economic Implications

(By Warren L. Smith, professor of economics, University of Michigan. Consultant: Joint Economic Committee, Commission on Money and Credit, Council of Economic Advisers)

I. INTRODUCTION

After being relatively quiescent for nearly five years, monetary policy has again entered an active phase in the last few months, and interest rates have risen markedly. Moreover, inflationary pressures are still present, and additional restraint will almost certainly need to be applied either through a further tightening of general monetary policy or by some other means. In view of important structural and environmental changes that have taken place in the financial system in the last few years, this seems to be an appropriate time for a reassessment of some aspects of the role of interest rates. In this paper, I shall attempt to contribute to such a reassessment, paying attention to some of the results of recent economic research.

II. INTEREST RATES AS A GUIDE TO MONETARY POLICY

Monetary policy, in conjunction with fiscal and other policies, should be directed at the achievement of suitable employment, price level, and growth targets. However, these targets are separated from the Federal Reserve's monetary actions by a considerable lapse of time and by a series of reactions in financial markets, product markets, and factor markets. Accordingly, it seems clear that the System must have some more immediate criteria on the basis of which to formulate and execute its policies.

On the question of the criteria to be used in conducting—and in appraising—Federal Reserve policy, there is an important difference of opinion.[1] Many economists believe that primary attention should be paid to the behavior of the money stock—indeed, it is often simply taken for granted that the objective of monetary policy is to control the money stock or its rate of growth. However, another group would emphasize interest rates and credit conditions as the primary guide for monetary policy. Since I count myself a member of the latter group, I shall try to make a case for this approach.

Let me begin by saying that I believe interest rates are the "cutting edge" of monetary and financial policy insofar as its effects on the demand for goods and services are concerned. A rise in interest rates increases the attractiveness of financial assets relative to real assets and raises the cost of borrowed funds which may be used to acquire real assets. I believe it is primarily through these effects on interest rates that changes in monetary policy produce their economic impact. In addition to interest rates, changes in the "availability" of credit also affect expenditures. To my knowledge, no one has yet succeeded in constructing a measure of credit availability that is independent of interest rates and reflects only forces at work on the supply side of credit markets. It seems incontestable that changes in credit availability are closely associated with changes in interest rates, although it is possible that the relationship varies according to circumstances. But in any case it is difficult to see why the stock of money itself should be an important explanatory variable in any of the major demand func-

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[1] See, for example, Milton Friedman, *A Program for Monetary Stability*, (New York: Fordham University Press, 1959), esp. pp. 84–101; Karl Brunner and A. H. Meltzer, *An Alternative Approach to the Monetary Mechanism*, A Staff Analysis for the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Congress, 2nd session (Washington: U.S. Government Printing Office, August 17, 1964); W. G. Dewald, "Free Reserves, Total Reserves and Monetary Control," *Journal of Political Economy*, LXXI, April 1963, pp. 141–153.

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tions for goods and services, nor do I know of any instance in which an effort has been made to establish such a relationship.

It is well understood that interest rates are determined by the interaction of the public's propensity to save, inducement to invest, and preferences for financial assets of various kinds, together with the monetary and perhaps to some extent debt management policies followed by the Federal Reserve and the Treasury. On the other hand, the stock of money has, until recently, been regarded by most economists as an exogenous variable directly under the control of the Federal Reserve. However, recent theorizing and research have made it clear that this is a decidedly oversimplified view. It is now recognized that the money stock is determined jointly by the public's preferences for money in relation to other kinds of financial assets, the changing yields on these assets, and the demand of the banks for free reserves, together with the monetary policy actions of the Federal Reserve.[2] Thus, both the money stock and interest rates are endogenous variables dependent on quite complex sets of determinants. There can be little doubt, however, that the Federal Reserve can by "cut and try" methods have its way with either the stock of money or interest rates within quite narrow limits if it chooses to do so. That is, if the Federal Reserve should set out single-mindedly to control the money stock by means of open-market operations, it should be able to accomplish such control in quite a precise way. Alternatively, the System could select some one from the spectrum of interest rates—such as the Treasury bill rate, the yield on long-term Treasury bonds, or the market yield on Aaa corporate bonds—as its target and control that rate quite accurately. And, incidentally, if some of the recent research on the term-structure of interest rates is correct, the determination of one interest rate from the spectrum would determine within relatively narrow limits the entire term-structure of rates.[3]

Although money possesses the unique characteristic of serving as a means of payment, the upshot of recent research is that money is merely one of a large number of financial assets, each one of which possesses special characteristics of one kind or another. It is quite possible that by appropriate use of its available policy instruments the Federal Reserve could control the volume of any of a large number of financial assets or liabilities—for example, the volume of bank loans, the stock of time deposits, the stock of savings and loan shares, or even the stock of corporate bonds. It is difficult to see why the money stock should be selected from the myriad of financial assets and liabilities as an object of special attention by the monetary authorities; indeed, there seems to be no reason why the quantities of any of these assets and liabilities should, in themselves, be matters of any great concern.

Due to the undoubted existence of a substantial lag in monetary policy, a responsible discretionary monetary policy must be based on forecasts of future economic conditions and must be adjusted more or less continuously as forecasted conditions change. This cannot, however, be done in an entirely scientific way, because forecasting is imperfect, because the lag in monetary policy is a distributed lag whose time profile undoubtedly varies to an unknown extent as conditions change, and because there is uncertainty concerning the magnitude as well as the time pattern of the impact of monetary policy. Thus, due to imperfect knowledge, it is still true, as Hawtrey said long ago, that central banking is an art rather than a science.[4]

Since imperfection of knowledge is an important problem, those responsible for monetary policy should conduct their operations in such a way as to minimize the amount of knowledge required. This suggests that if they have a

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[2] James Tobin, "Commercial Banks as Creators of 'Money,'" in Deane Carson (ed.), *Banking and Monetary Studies* (Homewood, Illinois: Richard D. Irwin, 1963), pp. 408–419; L. E. Gramley and S. B. Chase, Jr., "Time Deposits in Monetary Analysis," *Federal Reserve Bulletin*, LI (October 1965), pp. 1380–1406; W. L. Smith, "Time Deposits, Free Reserves, and Monetary Policy," unpublished paper delivered at Columbia University, 1965; Frank de Leeuw, "A Model of Financial Behavior," in J. S. Duesenberry, G. Fromm, L. R. Klein, and E. Kuh (eds.), *The Brookings Quarterly Econometric Model of the United States* (Chicago: Rand McNally and Co., 1965), pp. 464–530.

[3] Franco Modigliani and Richard Sutch, "Innovations in Interest Rate Policy," unpublished paper delivered at the meeting of the American Economic Association, New York, N.Y., December 28, 1965; also David Meiselman, *The Term Structure of Interest Rates* (Englewood Cliffs, N.J.: Prentice-Hall, 1962); Arthur Okun, "Monetary Policy, Debt Management and Interest Rates: A Quantitative Appraisal," Research Study Four in *Stabilization Policies* (Englewood Cliffs, N.J.: Prentice-Hall, 1963), pp. 331–380.

[4] Ralph G. Hawtrey, *The Art of Central Banking* (London: Longman's, Green and Company, 1932), p. 279.

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choice among the financial variables they can control with reasonable precision, they should place primary emphasis on the control of those variables most closely related to the spending decisions they are trying to influence. Thus, if it is true, as I contend, that (1) it is possible for the Federal Reserve to control interest rates and credit availability rather closely without detailed knowledge of the links between interest rates and the policy instruments available to them, and (2) interest rates and credit availability are the crucial variables through which monetary policy exerts its effects on the demand for goods and services, an interest-rate oriented monetary policy requires less knowledge and is therefore more efficient than a money-supply oriented policy. Or, to put it another way, an interest-rate oriented policy requires only a knowledge of the magnitude and timing of the effects of interest rate changes on the demand for goods and services, whereas a policy directed primarily at controlling the money stock requires *in addition* knowledge concerning the magnitude and timing of the effects of changes in the money stock on interest rates. Admittedly, knowledge is seriously incomplete in either case, but the degree of uncertainty is likely to be substantially greater when the money stock is selected as the major criterion of policy.

When I contend that interest rates and credit conditions are the best available guide for monetary policy, I do not mean that any single interest rate should be selected for this purpose. Monetary policy, like tax policy, has a particular incidence on the economy, and this incidence may be suitable under some circumstances and unsuitable under others. Indeed, the fact that an interest-rate orientation is conducive to this way of looking at monetary policy is one of its great advantages. Accordingly, the full range of interest rates that are likely to influence spending decisions, together with associated changes in the availability of bank credit, must be taken into account, and an effort must be made to judge the effects of changes in these interest rates and availability factors on the various components of demand, such as housing construction, plant and equipment expenditures, inventory investment, state and local government capital outlays, and consumer purchases of durable goods. Moreover, policy decisions must be based on forecasts, and some attempt must be made to judge the timing of the effects. Admittedly, this is a big order that requires that exercise of a good deal of judgment on the part of the Federal Reserve, but I can see no other defensible basis on which to conduct monetary policy.[5]

Of course, interest rates are bound at times to be an important constraint on the conduct of monetary policy under an international monetary system of the present type, characterized by fixed exchange rates, relatively unrestricted capital movements, and limited monetary reserves. Indeed, this was the case in 1961–65, when, as I interpret the situation, the Federal Reserve maintained the Treasury bill rate at a level that was felt to be required for balance-of-payments reasons—a level that was raised several times during the period—and the rate of monetary expansion was determined by the growth of credit demands at the configuration of interest rates that was consistent with the prevailing bill rate "target." Since the demand for money at a given set of interest rates presumably depends on the transaction requirements associated with the prevailing level of GNP, thhe growth of the money stock speeded up when the rate of GNP growth rose as a result of a strengthening of the forces of private demand or because of the adoption of a more expansionary fiscal policy. In particular, when the tax cut went into effect in early 1964 and caused GNP to rise more rapidly, the rate of growth of the money stock also accelerated.

It should be recognized that the limitations imposed on monetary policy by the balance of payments can cut both ways. If at some future time the United States should experience inflationary pressures combined with a balance-of-payments surplus, the constraint could operate to prevent the adoption of a restrictive policy involving sharp increases in interest rates. The constraint would probably not be as severe in this instance, because there is not the same limit on the magnitude and duration of a balance-of-payments surplus that is imposed

[5] If my argument is correct, it has a bearing not only on the strategy to be followed in conducting monetary policy but also on the choice of emphasis in a program of research aimed at improving its effectiveness. It suggests that the primary emphasis in research should be placed on the estimation of the size and time profile of the coefficients attaching to interest rates or other monetary variables in the equations explaining various categories of final demand for goods and services—that is, higher priorities should be placed on research of this kind than on investigations of relationships existing within the financial sector of the economy, such as the demand for money, the demand for time deposits, and so on.

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on a deficit by the existence of limited reserves. However, the use of a restrictive monetary policy involving high interest rates on the part of a country in balance-of-payments surplus might accentuate the problems of those other countries currently in deficit and therefore not be consonant with responsible membership in the world economy.

A comment on the use of free reserves as a guide to monetary policy is in order. The Federal Reserve has been strongly criticized by economists for the emphasis it has sometimes seemed to place on free reserves.[6] I have contributed to this criticism myself, and I believe the level of free reserves can be—and has been on some occasions—a misleading indicator, primarily because it is affected by changes in the relationship between the discount rate and short-term open-market interest rates. However, I believe the criticisms of the Federal Reserve on this account have sometimes been exaggerated. Under present institutional arrangements, changes in the level of free reserves, if interpreted carefully, can be of some value as one indicator of changes in the state of the credit markets. Moreover, on the basis of my observation, I believe there are many economists in the System who are capable of interpreting movements of free reserves in a very sophisticated way.

I want to make it clear that I am not saying that no attention should be paid to the behavior of the money supply. It would be foolish not to make use of evidence that may at times be helpful in evaluating the state of the credit markets. Indeed, there are some circumstances when attention to the money supply may be especially desirable. For example, in periods of recession, interest rates tend to fall automatically as credit demand declines. It is difficult to tell what level of interest rates would be needed to induce recovery, or even to sort out the influence of declining demand from that of deliberately expansionary policy measures. Assuming that the balance-of-payments situation does not stand in the way of a vigorous expansionary policy, the Federal Reserve can be reasonably sure that it is operating in the desired expansionary direction by seeing to it that the money supply continues to expand in such a situation. Nevertheless, I believe that under most circumstances, interest rates and credit conditions should be the main guide for monetary policy.

III. INTEREST RATES AND MONETARY POLICY IN THE PRESENT SITUATION

As a result of rather significant changes in the financial environment that have occurred since the 1950's, the rise in interest rates that has occurred in the last few months has evoked some new responses and raised some new problems that were not present in earlier periods of restrictive monetary policy. It seems useful to speculate concerning these responses and problems and also to attempt an evaluation of the desirability of a further rise in interest rates as a means of dealing with the particular kind of inflation that seems to threaten us.

As far as its effects on bank credit availability are concerned, monetary policy seems to be taking hold considerably more strongly and quickly than was the case in the 1950's. It seemed to me that a major factor which cushioned and delayed the impact of restrictive monetary policy in the period 1955–57 and again in 1958–59 was the fact that the banking system was in an extremely liquid condition—in particular that it held large quantities of U.S. government securities which it was able to sell in the market to obtain funds to expand loans even at times when Federal Reserve restraint prevented the money supply from growing significantly. Thus, restriction of bank credit availability did not begin to make itself felt until the banking system had worked its way through substantial portions of its holding of U.S. government securities. Great changes have, however, taken place in the composition of bank assets and liabilities since the mid-1950's, and the effect of these changes is to make a restrictive monetary policy take hold more quickly and more vigorously today than was the case a decade ago.

In January, 1955, at about the time when the first steps were taken to restrict credit in the 1954–57 expansion, the loan-to-deposit ratio of the commercial bank-

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[6] W. L. Smith, "The Instruments of General Monetary Control," *National Banking Review*, I (September 1963), pp. 47–76; Dewald, *op. cit.*; A. J. Meigs, *Free Reserves and the Money Supply* (Chicago: University of Chicago Press, 1962); Karl Brunner and A. H. Meltzer, *The Federal Reserve's Attachment to the Free Reserve Concept*, A Staff Analysis for the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, 88th Congress, 2nd session (Washington: U.S. Government Printing Office, May 7, 1964).

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ing system was 39 percent, and its ratio of U.S. government securities to total deposits was 38 percent. In October, 1965, when the Federal Reserve began to shift its policy toward restriction, the loan-to-deposit ratio stood at 62 percent, and bank holdings of U.S. government securities amounted to only 19 percent of deposits. Thus, between early 1955 and late 1965, the loan-to-deposit ratio of the banking system had risen by nearly three-fifths, while its ratio of U.S. government securities to total deposits had been reduced by about one half.

Paralleling the change in the composition of bank assets, there has been an almost equally dramatic shift in the composition of liabilities. In January, 1955, time deposits accounted for 27 percent of total deposits for the commercial banking system. By October, 1965, the ratio of time deposits to total deposits had risen to about 47 percent. This rise in the relative importance of time deposits has been particularly marked during the expansion that began in February, 1961, and is accounted for by the existence of lucrative lending opportunities that have made the banks desirous of attracting funds through time deposits, together with increases in the Regulation Q interest-rate ceilings which have enabled them to engage in such competition.

In view of the sharp increase in the relative importance of time deposits, one might expect the banks to be willing to carry somewhat smaller margins of liquid and safe assets than was the case a decade ago, since savings deposits and, to some extent, certain other categories of time deposits, are undoubtedly more stable than demand deposits and less likely to be a source of unexpected reserve drains. However, changes have occurred in the composition and sectoral distribution of time deposits which undoubtedly work in the other direction. In 1955, 86 percent of all commercial bank time deposits were held by the household sector of the Federal Reserve flow-of-funds accounts, with negligible proportions of the deposits held by other sectors. By 1965, this situation had changed quite drastically. The household sector now accounts for only 72 percent of total holdings of time deposits, while holdings of the non-financial business sector had risen to 15 percent, holdings of state and local governments to 8 percent, and foreign holdings to 5 percent. One of the main reasons for this increase in time deposit holdings by sectors other than households was the development of the negotiable time certificate of deposit, which began on a significant scale in 1961. Indeed, between early 1961 and the end of 1965, the total volume of CD's rose from virtually zero to about $16 billion. These instruments are for the most part held by sophisticated investors who are quite prepared to switch funds between CD's and short-term marketable securities in response to rather small changes in the relative yields on these two types of investments.

It seems to me that these changes in the banking system have increased the magnitude and speed of the reaction of bank credit availability to the application of a restrictive Federal Reserve policy, and have also changed the response mechanism of the banking and financial system. In the first place, in view of the sharp decline in their holdings of secondary reserves relative to deposits, the banks are now less willing and less able to meet expanding loan demands in the face of a restrictive Federal Reserve policy by selling liquid assets than they were in the 1950's. On the other hand, the banks now have another means available to obtain funds for lending: They can attempt to sell more CD's by raising the interest rates offered on these instruments (providing, of course, that there is leeway under the Regulation Q ceilings to permit this). Indeed, some of the larger money market banks have reduced their holdings of secondary reserves to minimum levels with the intention of relying almost entirely on their ability to attract additional funds when needed on short notice through the issuance of CD's.

In a sense, the sale of additional CD's by the banks to obtain funds to meet rising loan demand can be expected to have much the same effect on financial markets as would the sale of short-term securities from bank portfolios: Since CD's compete with marketable securities, an increase in the supply of CD's would tend to drive up short-term interest rates. Nevertheless, I believe the development of the CD—and the prospect of its increased use in the years ahead—has profound implications for the functioning of the banking and financial system and for the impact of monetary policy.

The increased price competition for funds among the banks and between banks and other financial institutions is probably, in general, a healthy development which should increase the efficiency of the financial markets in allocating capital. At the same time, it is a development that makes me somewhat uneasy.

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With some $17 billion of CD's outstanding—and the amount is still increasing steadily—a rise in short-term interest rates could, under some conditions, impose a considerable strain on banks. There was, for example, considerable foreboding concerning the ability of banks to refinance the large rollover of maturing CD's in March and April, although no great difficulty was in fact encountered. There could, of course, be no serious strain imposed on the banking system as a whole, since the most that could happen would be a shift of funds from time deposits to demand deposits as funds from maturing CD's were shifted into securities or used to pay taxes. This would increase aggregate required reserves, but the extra reserves could easily be supplied by the Federal Reserve. But inability to refinance maturing CD's could conceivably cause a severe liquidity crisis for the particular banks involved. The fact that some commercial banks have used CD's to attract funds which they have then invested in debt instruments of long maturity such as mortgages is especially disturbing.

The implications of recent developments in the financial markets for the stability of thrift institutions such as savings and loan associations are an even greater cause for concern. Some banks have recently begun to offer consumer certificates of desposit in relatively small denominations as a means of attracting deposits from small savers. This has the advantage for the issuing bank of enabling it to discriminate by offering a high rate to marginal savers to attract or hold their savings without offerng the same rate to all depositors. With the Regulation Q ceiling at 5½ percent, some banks have been offering interest rates of well over 5 percent on certificates of small denomination. The Federal Home Loan Bank Board has set an effective ceiling of 5 percent on the dividend rates of savings and loan associations. As a result, some associations have been subjected to a severe squeeze as a result of shift of funds by savers from shares to bank deposits. Indeed, competition from the banks appears to have been responsible for a decline in the rate of growth of savings and loan shares in recent months.

The situation that has developed means that a further significant increase in interest rates under present conditions might have two rather marked effects. First, it might result in a large-scale shift of funds from the thrift institutions to the banks, which would cause severe adjustment problems, conceivably of crisis proportions, for the former. This could not be prevented by holding to the 5½ percent Regulation Q ceiling, since this would mean that banks would have difficulties in rolling over large blocks of maturing CD's. It would probably not solve the problem to permit savings and loan associations to raise their dividend rates to compete with the banks. Savings and loan investments are of long maturity, and some associations would suffer a severe profit squeeze if they had to raise dividend rates sharply to hold funds that are invested in mortgages that had been acquired when yields were lower. Banks can afford to pay high rates to attract the funds they need to grant relatively short-term accommodation to their established customers. Thus, the banks with their diversified portfolios seem to have a competitive advantage over savings and loan associations whose portfolios are confined mainly to long-term debt by both regulation and tradition.

The second effect of the recent developments in financial markets is that a further application of credit restriction might fall with special severity on residential construction, as funds were diverted away from savings and loan associations which invest primarily in mortgages to banks which are seeking funds to accommodate their business customers. This would intensify an effect which is already present—that is, tight money already appears to have had a substantial effect on the availability of mortgage credit. This is partly due to the existence of ceiling interest rates on FHA-insured and VA-guaranteed mortgages and the resistence to heavy discounts on these mortgages, which have caused funds to flow into other markets where yields are more attractive. No doubt the effects have been lessened by the two recent increases in the ceiling rates by the VA and FHA that have been made recently, but they have nevertheless been present.

The problems created by the recent developments in the CD market for competition between banks and thrift institutions are difficult to deal with. One possibility would be to place a lower limit on the denominations of certificate of desposit in order to eliminate competition between certificates and savings and loan shares. This would be unfair to small savers who are entitled to obtain the highest return the market will offer for their savings. Nevertheless, it

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might be appropriate as a short-run measure while more fundamental reforms were being worked out. These would include the introduction of some diversity and flexibility into the portfolios of savings and loan associations as a means of making them less vulnerable and better able to compete for funds. In addition, it would be desirable to provide some means of giving savings and loan associations direct or indirect access to Federal Reserve to protect them against liquidity problems resulting from large-scale withdrawals of share accounts.

To summarize, monetary policy is likely to have quite severe effects on the availability of bank credit under present conditions. And although the empirical evidence based on past experience is not clear cut, it seems likely that the impact of reduced availability will fall primarily on new and small enterprises which are heavily dependent on bank financing. For reasons already set forth, there is also likely to be a strong restrictive effect on residential construction. In addition, the rise in interest rates has caused some cancellations or postponements of borrowing by state and local governments, and this will doubtless result in some deferrals of capital outlays. The most dramatic example of this was the cancellation in March of the $440 million New Jersey Turnpike Bond Issue. It seems likely that this bond issue will be postponed for several months and that the high cost of financing will result in some significant postponement of the actual expenditures associated with the Turnpike project. There are some indications that similar effects have been produced on other state and local government projects as well.[7]

The possibility that the bite of monetary policy will be greater now than was the case in the 1950's should be borne in mind in formulating a strategy for economic stabilization. I would judge that we may already have in the works a reduction in expenditures primarily for residential construction and state and local government capital projects, with some effects on business capital expenditures mainly by smaller firms and possibly on demand for consumer durables through reduced availability of consumer credit, which might add up to $2 to $3 billion by the third quarter. Applying a multiplier of two to this reduction in expenditures yields an estimate of perhaps $4 to $6 billion for the effect on GNP during the fiscal year 1967. If the monetary measures already taken have set in motion restrictive effects of this magnitude, this fact should certainly be taken into account in deciding what, if any, further anti-inflationary measures should be adopted.

In deciding whether further use should be made of restrictive monetary policy in the present situation, careful attention should be given to the nature of the inflationary pressures with which the economy appears to be threatened. The most striking characteristic of the current expansion during the first three years or so was the reasonably good balance that was maintained among the rates of growth of the major components of demand. More recently, however, the expansion has developed some imbalance in the sense that business fixed investment has been increasing much more rapidly than the other elements of demand. And surveys of business investment intentions indicate a still further acceleration in the coming months.

Past experience seems to indicate clearly that an investment boom of the present magnitude is bound to cause trouble unless it can be brought under control. For one thing, the rapid increase in plant and equipment expenditures is already placing heavy pressure on plant capacity and the labor supply in the metals and machinery sector of the economy. A good deal of the rise in both the wholesale price index and the consumer price index that has taken place in recent months has been due to increases in food prices resulting from changes in supplies of agricultural products which are capable of being affected only very slightly by any reasonable change in either monetary or fiscal policy. However, there have also been some increases, particularly in the last few months, in industrial prices, and if business plant and equipment outlays continue to expand at rates indicated by recent surveys of investment intentions, they can hardly fail to produce the kind of sectoral inflation that we experienced in 1955–57. And this inflation, though its effect on materials used in a wide variety of consumer products and on the general wage level, is almost certain to infect the whole economy in the course of time, again as happened in 1955–57.

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[7] A survey of the columns of *The Weekly Bond Buyer* and *The Wall Street Journal* indicates that a sizable number of postponements or delays of municipal bond issues occurred between late December and late April, although it is difficult to make a quantitative appraisal of the effects on either the volume of funds raised or the level of municipal capital outlays.

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In addition to the danger of sectoral inflation stemming from an unduly rapid increase in plant and equipment expenditures, there is a further danger that excessively rapid and continuing rise in such expenditures far out of line with the overall rate of expansion of aggregate demand, will lead to the creation of excess capacity in some industries. This, in turn, can undermine the inducement to invest, lead to a decline in business outlays for plant and equipment and bring on a recession.

Thus, it seems to me that the prime objective of monetary and fiscal policy under present conditions should be to produce a tapering off of business outlays on plant and equipment with a view to achieving a pace of investment in relation to total growth of output and in relation to the resources available for the production of investment goods that will be sustainable without generating either excess capacity or sectoral inflation in investment goods industries. This suggests that the appropriate policy instrument to be used in dealing with the present inflation would be one whose effects are felt primarily on business plant and equipment expenditures. A generally restrictive monetary policy of the sort the Federal Reserve has been following in recent months will undoubtedly have some effect on business investment outlays. Despite several econometric studies in the last few years that have uncovered significant interest rate effects on business investment, however, I must confess considerable doubt as to whether these effects are likely to be of major significance in the present highly ebullient investment climate.

My own judgment, based partly on observation of developments in the 1950's and partly on an appraisal of recent developments in the financial markets as outlined above, is, as I have already indicated, that a restrictive monetary policy is likely to have its major effects in such areas as residential construction and possibly outlays by state and local governments. Housing starts and residential construction expenditures have been doing no more than holding their own for some time now, and there is some danger of deepening the doldrums already affecting residential construction without doing very much to temper the inflation that may result from an unduly rapid expansion of business outlays on plant and equipment. Moreover, even if a restrictive effect that falls primarily on residential construction and state and local government expenditures does help to check the inflation because these sectors compete for resources with the rapidly growing outlays for business investment, a restriction of demand in these sectors will probably do little to lessen the danger that excess productive capacity will develop, leading eventually to a curtailment of investment spending.

By the same token, it does not seem to me that an increase in the individual income tax is an ideal measure for dealing with the kind of inflation we now appear to be threatened with. Such a tax increase would have its primary effect on consumption expenditures and would be unlikely to have an appreciable direct impact on business investment. Since some of the consumer expenditures which would be curtailed by an increase in individual income taxes undoubtedly compete for resources with business investment, such an increase in taxes would have some tendency to temper inflationary pressures. However, I doubt if it would be a very efficient instrument in this regard, because much of its impact would probably fall on types of expenditures which are not generating significant price pressures. Furthermore, a sharp reduction in consumer expenditures unaccompanied by any immediate moderation of the investment boom might increase the danger that excess capacity might appear in some consumer goods industries.

It seems to me that the best instrument for dealing with the present inflationary situation would be one that was pinpointed in such a way as to fall primarily on business investment demand, growth of which seems to be the primary cause of our difficulties. In many ways, the most appropriate measure that could now be taken would be a temporary suspension of the 7-percent investment tax credit that was enacted in 1962. Suspension of the credit might be expected to have a quite powerful effect on business investment spending without producing any direct impact on the other components of final demands.[8]

[8] If straight-line economic-life depreciation is used, an asset having a 10-year life and yielding 5.9 percent with the credit would have its yield reduced to 4.4 percent if the credit were suspended. Since interest is deductible for tax purposes, the incentive effect is equivalent to a rise of about 3 percentage points in the interest rate, assuming that the investor is subject to the 48 percent corporate income tax. In addition to its incentive effects, suspension of the credit would also have a sizable impact on cash flow.

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The fact that the credit would be restored when the present investment boom had been adequately tempered would provide a powerful incentive for the postponement of investment spending, since such postponement would enable the firms involved to obtain the credit at a later time. Admittedly there are serious difficulties connected with suspension of the credit. The major technical problem seems to lie in the fact that business firms receive the credit at the time of installation of capital equipment rather than at the time their investment plans are made. However, it should be possible to find some way around this difficulty. Considering the apparent structural aspects of the current boom, suspension of the credit appears to be the most appropriate measure in the present situation.

IV. CONCLUDING COMMENT

I have used the topic relating to interest rates that was assigned to me as a peg on which to hang some observations regarding strategy in the conduct of monetary policy and regarding the measures that it seems to me would be appropriate to deal with the present inflation. That is, I have not tried to deal in a general way with all of the economic implications of interest rates but have chosen rather to focus attention on some specific issues that seem to me to be of considerable significance in the present context.

[From the American Banker, Mar. 11, 1966]

ANALYSTS SEE PRIME RATE BOOST AS "BULLISH" FOR BANK STOCKS, "BEARISH" FOR INDUSTRIALS

(By Trevvett Matthews)

NEW YORK.—"Bullish for banks stocks, but bearish for industrials," was the opinion of analysts on the prime rate boost announced Thursday by major money market institutions.

All of the analysts expected the rate increase to stick, contrary to the experience of November, 1964.

Banks "are just following the market rates," said Richard McNiven, assistant vice president, Clark, Dodge & Co., who termed the increase "very bullish."

He cited the 75 basis point rise in CD rates since the December 6 action by the Federal Reserve as contrasting with a 50 basis point rise in business loan rates in the same period, and said the banks had "no choice."

"Look at the prices," said Joseph Barone, senior bank analyst, Goodbody & Co., "they tell the story."

Prices were up from a half to a full point during the day.

Most of the better acting shares were those of banks which are heavy in business loans carrying the prime rate, reported David Cates, senior analyst with Salomon Brothers & Hutzler.

Mr. Cates expressed concern on the possibility that Regulation Q might be lifted, thereby opening the way to a higher savings rate and higher cost money for commercial banks.

There is, said Mr. Cates, "the barest anxiety" that Regulation Q might be lifted.

One point, whether the rate increases woud benefit banks generally or selectively, was in slight dispute among the analysts.

The strongest view was that benefits would go across the board, and not be limited in the least to banks heavy in prime rate loans. This was expressed by Harry Keefe, president, Keefe, Bruyette & Woods, Inc.

The last round of rate increase, said Mr. Keefe, showed that banks with loans at negotiated rates were more successful in increasing their yields than were the banks with much of their money out at the prime.

Also, the consumer loans are already up from the last boost, he noted in backing the thesis that bank gains would be general and not selective.

Ian Ruxton, analyst with Tucker, Anthony & R. L. Day, agreed that "across the board improvement in earnings" would follow the rate boost.

Citing his January prediction that earnings would rise in the 7%–10% range this year from 1965, Mr. Ruxton said the higher prime means the gain should be about 10%.

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The boost, Mr. Ruxton added, "has improved the defensive quality of bank stocks."

One question which poses a possible threat, said Mr. Ruxton, is where the CD rate will go. Following the last boost in loan rates, he noted, CDs showed exceptional ability to rise.

Banks, he fears, will be more inclined now to bid CDs up toward the 5½% ceiling.

This possibility, while a very real one, should not be long-lasting if it does develop, said Mr. Ruxton. He said any such rise will probably subside in the second quarter, if it does occur.

George Hacker, vice president, M. A. Schapiro & Co., Inc., while expecting higher bank earnings to result from the prime rate boost, sees the best rises for banks which are heavy in prime rate loans.

These institutions, he noted, get an "automatic" increase in their return. Also, said Mr. Hacker, banks heavily loaned in consumer credit, which is at set contract figures, will not be able to adjust any of these loans.

Goldman, Sachs & Co., with Wall Street's newest bank stock department, believes that banks will be able to keep more of the higher yield this time than after the last rate boost, an analyst said.

He cited the rapid boost in CDs which other analysts referred to, and said it should not develop this time.

The opinion on commercial finance corporations and consumer finance corporation effects was generally mixed for the former and unfavorable for the latter.

Citing a $50 million borrowing by an insurance company in recent weeks, Mr. Keefe said heavy bank credit use was being made by "people not normally into banks."

[From the Washington Post, May 18, 1966]

Fed Governor Would Add to Mutual Role

(By Paul G. Edwards, Washington Post Staff Writer)

Federal Reserve Board Vice Chairman J. L. Robertson proposed yesterday that Savings and Loan Associations and mutual savings banks be allowed to provide checking accounts and make general purpose loans.

Unless this long range transition is undertaken, Robertson said, mutual financial institutions may not survive the competition for time deposits now offered by commercial banks.

Robertson made his proposal in a speech to the Illinois Bankers Association in Peoria. A text was released in Washington.

MUTUALS' EXTINCTION FEARED

He said that regarding the Mutuals as permanently tied to specialized functions may cast them in the role of the prehistoric brontosaurus, a mammoth dinosaur that passed into extinction because it failed to adapt to changes in the North American environment.

He warned the commercial bank that although mutual institutions are now under pressure, the tables could turn.

In the absence of a uniform reorganization of the depository system, he said, mutuals might win legislative relief in the form of expanded lending powers while their tax and regulatory advantages go unaltered. In that event, he suggested, it might be the commercial banks that go the route of the brontosaurus.

PROPOSES BALANCED APPROACH

To head off the prospect of Darwinism ruling the banking world, Robertson proposed a broad and balanced approach to the problems of the mutual institutions.

They must be given new lending powers, he said, but "they must relinquish the special privileges that were designed to assist them in developing as specialized thrift institutions."

"In other words," the Governor said, "with the powers of a commercial bank must go the burdens."

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"... I propose that all depository institutions be permitted to become comprehensive lenders and borrowers, subject to uniform bank-style limitations on the exercise of their powers."

POINTS TO PRECEDENTS

Robertson said the proposal was not visionary. He pointed out that mutual institutions had been converted in the past to stock companies.

Legislation to authorize acceptance of demand deposits and the making of a broad range of loans could accomplish the same thing, he said.

Robertson said it may take decades to accomplish the full breadth of the reforms he proposes. But he argued the recent rise of interest rates paid by banks has put such pressure on mutual institutions tied to limited lending functions that a start toward reform must be made.

[From the Wall Street Journal, June 13, 1966]

HORNE'S EMERGENCY PLAN—SLUMP IN HOUSING STARTS ANTICIPATED BY S. & L. OVERSEER BECAUSE OF CD'S

(By Richard F. Janssen, Staff Reporter of The Wall Street Journal)

WASHINGTON.—Housing starts will fall steeply soon unless the ability of banks to drain funds from mortgage-issuing savings and loan associations is restricted, cautioned John E. Horne, the Government's chief S&L supervisor.

Mr. Horne is discussing with banking authorities a proposal to let the Federal Reserve, in case of emergency, pump newly created money directly into the savings and loan system.

Mr. Horne, chairman of the Federal Home Loan Bank Board, predicted in an interview that, unless either Congress or the Federal Reserve Board curbs banks in issuing high-yielding certificates of deposit, housing starts in the second half of this year will decline to an average annual rate of 1,270,000 to 1,100,000. That would put the full year's total around 1,300,000, down 13% from the 1,505,000 of last year. Not since 1961 have housing starts been under 1,400,000.

The chairman said he wishes Congress would slash to 4¾% or even 4½% the maximum interest rate on CDs of less than $100,000. In contrast, Federal Reserve Board Chairman William McChesney Martin and Treasury officials appear to favor a ceiling of 5% on these "consumer sized" CDs. The present limit is 5½% annually.

SMALLER CD'S CAUSE WORRY

CDs are receipts for funds deposited for a specified time. Big ones are usually negotiable; depositors can receive their money in advance of maturity by selling them to a dealer. It's the increasing use of smaller non-salable ones that's worrying the savings and loan industry. Without Congressional authority, the Federal Reserve Board doesn't believe it could vary the rate ceiling according to size.

A 5% ceiling on the smaller certificates would cause some reduction of the current drain on savings and loan associations, Mr. Horne said, but he fears it still wouldn't be low enough to assure S & Ls "adequate funds to meet the responsibility Congress charged them with, of providing sound and economical home financing."

Mr. Horne disagrees with Mr. Martin on CD maturities, too. He said the Federal Reserve should act on its own to require that CD have maturities of at least six months if not a year. Mr. Martin has said this would be unfair to small banks that issue such certificates in place of passbook savings account.

The practice of letting CD holders cash them in every 90 days instead of holding them to maturity also should be halted, Mr. Horne asserted.

HORNE'S SCHEME

The Horne emergency plan for bolstering savings and loan resources would require action by Congress to make securities issued by the Federal Home

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Loan banks eligible for purchase by the Federal Reserve. Some of these securities would be sold directly to the reserve system instead of being offered on the open market to compete for existing savings. If the Federal Reserve were to buy such issues, it would mean a net increase in the nation's money supply because of the Federal Reserve's power to create the funds with which it makes securities purchases.

Such a law, Mr. Horne said, would put the Home Loan banks "in a better position to relieve some of the strain on the mortgage market." He complained that present Home Loan Bank debentures can't be offered more than once a month "and there is some limit to how big a chunk of funds we can obtain" at any one time. Selling these debentures provides funds for the 12 district Home Loan banks to lend to member associations.

The Federal Reserve would decide whether to make such purchases, and they probably wouldn't be made except to meet "emergency" needs of associations. So far, board officials haven't had any response from the Federal Reserve, but they believe there's some sentiment for the idea in Congress.

HOME LOAN RESOURCES

The Home Loan Board will have exhausted its ability to aid the competitive stance of savings and loan asociations once it issues the rule changes it proposed in mid-May, Mr. Horne said. Unless Congress, in the meantime, restricts the rates banks can offer on CDs, on July 1 the board probably will begin letting associations, among other things, pay up to 5% on regular passbook accounts in California and Nevada without losing their borrowing power at the district banks. If Congress does curb bank CD rates, though, Mr. Horne hinted that the board might be less liberal in its rule changes.

Some associations, Mr. Horne complained, have entered "a state of undue caution" about mortgage-fund shortages by telling would-be borrowers they are "completely out of the lending business." Some banks and insurance companies have said the same thing to prospective mortgage borrowers, he said, calling this "obviously an extreme response to . . . a difficult situation." He expressed hope that associations soon will realize that their repayments on older loans provide funds for new loans even though their new-savings inflow is small or nonexistent.

Yesterday, in Atlanta, C. A. Duncan, Jr., president of the U.S. Savings and Loan League, said that new loan commitments by S&Ls fell 50% in May from the year-earlier level. The calculation was derived from a special survey made by the trade group of league members with 20% of the nation's savings and loan assets, he said.

The May decline, plus a 20% year-to-year drop in April, "foreshadows a severe cutback in home building and real estate sales as the year moves along," Mr. Duncan told the annual meeting of the Georgia Savings and Loan League.

COMMENT BY CHARLES J. SCANLON, PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO, CONCERNING ACCESS TO FEDERAL OPEN MARKET COMMITTEE DELIBERATIONS

MAY 27, 1966.

I must disagree completely with Mr. Patman's statement that the Presidents of the Federal Reserve Banks "go right back and report to their directors" what transpires at Federal Open Market Committee meetings. This is unthinkable, and it just is not done.

Our directors understand when they come on our Board that they are not going to have access to the deliberatons of the Federal Open Market Committee. They are responsible academicians, bankers, and businessmen, and having been informed that this information will not be made available to them, I have never had a director even inquire regarding the proceedings at a Federal Open Market Committee meeting. People might conjecture, as Mr. Patman has done, that directors know what goes on at Federal Open Market Committee meetings, but it is not conjecture on my part, it is firsthand knowledge—I have never made such a report to a director.

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(Representative St Germain submitted the following letter for the record:)

THE WASHINGTON TRUST CO.,
Westerly, R.I., May 26, 1966.

COMMITTEE ON BANKING AND CURRENCY,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: As the President of this forty-five million dollar bank which first opened its doors about eight months after George Washington died, I am concerned that a condition presently exists in this country where commercial banks are led to pay higher rates for "hot" money than for true long-term "savings" money. I refer to the Certificate of Deposit and the 5½% rate limit thereon as compared to the 4% limit set also by Regulation Q on savings accounts. The new type negotiable certificate of deposit and the even newer small savings "bonds" or "notes", I am firmly convinced, are largely responsible for most of the cut-throat rate wars presently going on between the various classes of financial institutions.

The mutual savings bank, the savings and loan association, and the small town commercial bank have historically paid a fair and high rate to the saver whose myriad of small deposits create a real solid hard core of long-term lendable funds. Suddenly these institutions, which form the backbone of literally thousands of communities across this country, are facing the loss of these deposits which are now being drawn in to the large commercial bank for use in short-term high-risk loans.

In some cases, especially in the area of the large denomination CD taken by a major bank in a large city, these "time deposits" can just as readily turn into "time *bombs*" set to go off unless emergency measures detrimental to the whole country's economy are taken. In the case of the small certificate of deposit, it is apparent that an attempt is being made to circumvent the 4% savings rate set by Regulation Q. For instance, there is at least one reputable and well-managed bank in the immediate New England area which is offering a "Note" or CD in denominations less than $40 and which bears a rate one-quarter percent higher than that paid by mutual savings banks in the same city. While these certificates of deposit have a maturity of five years, they may be redeemed without loss of interest at any time earlier upon 90 days' notice. The type of depositor who is attracted to this instrument is the same type who otherwise would be buying a Series E Savings Bond or who saves regularly at a mutual savings bank or savings and loan association. Now the commercial bank offering these small certificates of deposit actually has another very great advantage over the other savings institutions for the following reason: It pays the increased and higher rate of interest only on this new supply of "stolen" deposits. On the hard-core savings accounts at the same bank which are owned by people not moved to action by rate wars (either through ignorance or lethargy) the rate is still only 4%—which is less than what the mutual savings institutions are paying. The result is that the large commercial bank is stealing deposits from the mutuals and the savings and loans while it is actually costing them less per dollar of total deposits than it is costing the competition.

Certificates of deposit are not, to my mind at least, a *necessary* part of an upward move in the economy. This is proved by the fact that a healthy, steady growth was experienced before they came into being and since their arrival on the scene here has been a rather sudden and accentuated increase in rates. This increase has taken place at a time when rates were already at near historically high levels. The net result of higher rates has been higher costs to the borrower (who can ill afford them)—and more income to the investor (who was already pretty well off). This doesn't seem to be exactly the way one would have planned an important part of an anti-poverty program or, for that matter. any solidly founded economic program of conservative expansion for a great country.

It would seem that a program aimed at the orderly reduction and final outlawing of the use of certificates of deposit would tend to slow down investment in new risk ventures and would create a flow of funds back into solid savings and more conservative residential financing. Perhaps such a program could be an outgrowth of the present hearings before your Committee.

Sincerely,

ROBERT B. PERRY, *President.*

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(Mr. Strunk, executive vice president, United States Savings & Loan League, submitted the following information for the record:)

UNITED STATES SAVINGS & LOAN LEAGUE,
Chicago, Ill., April 11, 1966.

Hon. WILLIAM MCCHESNEY MARTIN, Jr.,
Chairman, Board of Governors,
Federal Reserve Board, Washington, D.C.

DEAR CHAIRMAN MARTIN: My last letter to you, dated December 13, 1965, followed receipt of the news of the change in the discount rate and the change in Regulation Q. We were primarily concerned at that time, as we are now, with the change in Regulation Q.

In view of developments since last December, we are convinced our concern at that time was more than justified. The decision of the Board of Governors to raise the permissible rate on commercial bank time deposits to 5½% opened a Pandora's box in the savings marketplace and has provoked a "rate war" for savings in which the financial institutions in the country are now engaged. In our view, this price war in the savings market is most regrettable and can only result in a weakening effect upon financial institutions generally.

We recognize full well that decisions and policies of the Board of Governors were made in the belief that increased rates and tighter money were necessary to inhibit the development of inflationary pressures in the United States. Thus, the program of monetary restraint in high interest rates inaugurated by the Federal Reserve Board evidently has been inadequate to prevent a serious inflation threat. The threat of inflation is, in our judgment, considerably more serious today than it was early last December.

On behalf of the savings and loan business, the United States Savings and Loan League is urging President Johnson and members of Congress to take measures in the fiscal area designed to curb the inflation threat. We believe that you should be aware of these efforts and we would hope that in the interest of promoting stability in the economy the Board of Governors of the Federal Reserve Board would express itself to the White House and to the Congress on the same subject. Perhaps it is time for the Federal Reserve Board itself to acknowledge, as many now acknowledge, that heavy dependence on monetary policy in fighting inflation cannot be regarded as a complete success.

As you recall, our original concern over the change of Regulation Q was that it foreshadowed a serious diversion of funds away from housing and home ownership. Our forecast has been validated in recent weeks; housing starts in February were 17% below the same month a year ago and we would be surprised if this decline does not continue over at least the next few months. Recent monetary policy decisions have meant, in other words, that the housing industry has been affected more adversely than any other major industry. Certainly the Board recognizes that the housing industry has been in a depressed state for several years and has not contributed to the inflationary pressures of recent years.

We urge, therefore, that the Board undertake a reconsideration of recent decisions with a view of determining whether these decisions have not imposed an unduly and unfairly heavy burden and hardship upon the home building industry and the real estate business.

The second part of our objection to the change in Regulation Q was that the change would mean a substantial shift in funds from smaller banks and specialized financial institutions into large money market banks which would be able to pay the highest rates on certificates of deposit. We realize that you personally called for "prudence" in the use of the new ceilings. Day by day, however, the evidence mounts that your warning has been disregarded by many banks.

In all frankness we are not reassured by the March 21st publication of your survey of use of new time deposit ceilings as of December 22, 1965. A survey of that date must be regarded as very much out of date since many hundreds of banks have been moved to high rates since December 22. Furthermore and of even greater importance, your survey was based on the number of Federal Reserve member banks offering high rate statistics. A more accurate analysis of the extent to which the banking business of the country has taken advantage of the new ceilings would be gained by a survey of the extent to which the major banks of the country have undertaken promotion of these small denomination certificates of deposit.

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We have undertaken such a survey of the hundred largest banks in the country which hold nearly 50% of all deposits of the commercial banking business. Our survey reported that more than three-fourths of the hundred largest banks offer "consumer CDs." These 78 banks hold over 40% of all commercial bank resources in the country. Very clearly, the offering of these consumer CDs at rates approaching and exceeding 5% by the banking business is considerably greater than the survey reported by the Federal Reserve Board on March 21, 1966.

We urge, therefore, the Board of Governors to make a new survey to find out exactly what the banks—and particularly the large money market banks—are doing in promoting savings certificates. We suggest that a survey today would reveal a substantially different picture than was reported in your survey on December 22.

The change in Regulation Q last December was restricted to time deposits, which indicated a hope or belief on the part of the Federal Reserve Board that the new time deposit ceilings would not be used primarily in competition for personal savings. Of course, the tremendous volume of newspaper advertising announcing the availability of small denomination certificates of deposit and savings certificates makes it clear that the new ceilings are being used to an ever increasing extent in the solicitation of personal savings. Unless some new restrictions are imposed on time deposits, therefore, there promises to be increasing disruption of the savings market.

Two possible and constructive restrictions on time deposits immediately available to the Federal Reserve Board are (1) to prohibit the issuance of certificates with more than one maturity date, and (2) to eliminate the automatic renewability feature on certificates issued in the future.

Perhaps the most ironic and bitter twist of the hectic events in the savings market since early December is that the "rate war" in the savings market has done so little to promote savings in financial institutions. The growth of time deposits and savings in commercial banks during the first quarter of 1966 was much lower than in the corresponding quarter in 1965. The growth in savings accounts in mutual savings banks was lower in the first quarter of 1966 than it was last year. The growth in savings balances at savings and loan associations was considerably lower in the first quarter of this year than in the first three months of last year. Thus, banks and financial institutions over the country are paying more for savings and time deposits and are attracting less. By any measure, this must be reckoned as a hollow and expensive victory even for the few big banks that have grown in recent months.

Changing the rules under which certificates of deposit are issued, as outlined above, with respect to dual maturities and automatic renewability would be consistent, we believe, with the Board's objectives as to savings deposits outlined in your speech in December to the Life Insurance Association of America. At that time you indicated that the Board desired "to minimize the impact on competitive relationships between commercial banks and savings banks and savings and loan associations, which depend for their resources mainly on funds deposited by individual savers rather than by corporations."

In closing, we cannot urge you too strongly to pursue with the greatest vigor at your command your efforts to police the volume and nature of commercial bank lending because this is the heart of the matter. Commercial bank loan-to-deposit ratios are higher than they have been in virtually any other period in our economic history. A good part of the inflationary pressures could be checked by greater selectivity in commercial bank lending.

In connection with some restraint in commercial bank lending, the Board of Governors might appropriately, we believe, ask for some voluntary restraint or reduction in the total amount of credit extended by the commercial banking system in the consumer credit area. This would urge some reduction both in the total amount of consumer credit extended by the commercial banks directly and also the extent of commercial bank financing of sales finance and other consumer credit companies.

We congratulate you most heartily on the fact that you have urged restraint and caution in commercial bank lending, and we urge further and renewed efforts along these lines.

Sincerely,

NORMAN STRUNK,
Executive Vice President.

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[From the American Banker, May 26, 1966]

Housing Market Pinch Will Continue: Strunk

Salt Lake City.—Tight money will continue to pinch the housing market with a disproportionate severity "as long as the President refrains from asking for an income tax increase or until there is some change in Viet Nam," Norman Strunk, executive vice president, U.S. Savings & Loan League, said Wednesday.

The current slowdown in housing starts, said Mr. Strunk, at a joint meeting of the Utah Savings and Loan League and the Salt Lake City Chamber of Commerce, is only the beginning of a major slump in new housing construction.

Asserting that high interest rates are having little effect on booming consumer spending in other areas, the league official deplored "the acute shortage of mortgage funds" in many parts of the country.

Mr. Strunk said that if Congress will pass legislation to limit commercial banks' use of certificates of deposit, the flow of funds into savings and loans would ease "to some extent" the pressure on mortgage credit.

Other types of institutions have almost terminated their mortgage lending while seeking higher yields elsewhere, thus increasing the loan demand at savings and loan associations, Mr. Strunk said.

Besides experiencing this added demand for loans, S&Ls have been hit on the supply side with a drain on funds due to the 5½% ceiling allowed commercial banks issuing certificates of deposit, he said.

This means that many lenders are "refusing to talk to home builders about plans for next summer and fall," said Mr. Strunk. In addition, he added, some lenders are even "drastically" reducing their financing of existing houses.

"The family with superior credit and a lot of money to put down can get a home loan, but the factory worker, clerk or young family—those able to put down only 10% to 20%—find doors closed to them," he said.

Funds generated through repayment of existing mortgages are keeping savings and loans in the market in some instances, he added.

The dark side of the mortgage picture was Mr. Strunk's main concern, but he was not pessimistic about the future of savings and loan associations.

Earnings are good, and only top quality loans are being made, he said.

"A somewhat slower growth for a few years is not necessarily an unhealthy thing for our business, although slower growth means we cannot make a lot of the good loans that are available today." In the postwar period according to league figures, savings share accounts have risen as much as 13% in a single year.

Memo to Members of House Banking and Currency Committee on Certificates of Deposit

(By Norman Strunk, Executive Vice President, United States Savings and Loan League)

June 8, 1966.

A survey completed yesterday by the United States Savings and Loan League indicates that loan commitments made by savings and loan associations in May of 1966 are down 51.1% compared to May of 1965. The following figures are a sample of 143 savings and loan associations throughout the United States with total assets of $16.4 billion. It is a random sample and reflects national trends.

Changes in loan commitments made

	1965	1966	Change	Percent change
April	$390,695,000	$312,725,000	−$77,970	−20.0
May	455,104,000	222,681,000	−232,423	−51.1

In addition to the severe reduction in loan commitments being made, interest rates have risen from 5½% to 6%, with rates of 6½% to 7% not unusual. Further, the required downpayments have increased considerably.

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These figures show conclusively that under the present trend the home building and real estate markets will be drastically reduced. Unless there is prompt action, the trend will be accelerated.

We respectfully urge the House Banking and Currency Committee to enact the following provisions on an interim basis:

1. Limit consumer CDs to one maturity date and eliminate the automatic renewal provision.
2. Have a minimum maturity of six months for consumer CDs.
3. Have a maximum rate of 4½% on consumer CDs. *A 5% ceiling simply will not eliminate the diversion of funds from the home mortgage market or reduce unhealthy rate competition between commercial banks and thrift institutions.*
4. Effectively limit high rate CDs to corporate depositors in large amounts.
5. We would also recommend that reserve requirements for CDs be permitted between 6% and 10%. We would like to stress the importance of immediate action if an even more severe decline in home financing is to be prevented in the next few weeks.

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New York University
Graduate School of Business Administration
C. J. Devine Institute of Finance

The Bulletin

No. 39, April 1966

Eurodollars: An Emerging International Money Market

By Ernest Bloch

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C. J. Devine Institute of Finance

Graduate School of Business Administration

New York University

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JOSEPH H. TAGGART, *Director*

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Bulletin No. 39

April 1966

Eurodollars: An Emerging International Money Market

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Foreword

The 1960's may well best be remembered as an era of financial innovation. In the banking sphere alone, "inventions" such as the C.D., the subordinated debenture, and the Eurodollar—largely unknown a few years ago—have become established financial instruments. Financial ingenuity, while always fascinating, is not always important nor easily understood. In the case of the Eurodollar market we have a new tool that is at once intriguing, significant, and mysterious.

Professor Bloch has sought to dispel the mystery by reviewing the conditions that induced the innovation and by tracing the process of financial intermediation in which Eurodollars are created. Clearly delineated is the way in which this new money market instrument is used by major banks at home and abroad to increase their liquidity and lending capacity in both domestic and international finance.

The study concludes that the Eurodollar plays a useful role in linking together the imperfect money markets of the world by serving as a source of bank credit or reserves. Provided that United States short-term capital outflows are not further restricted and that European markets are not efficiently integrated, the Eurodollar market is not only expected to survive, but its usefulness will tend to integrate it with more orthodox parts of the international financial machinery.

JOSEPH H. TAGGART, *Director*

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Acknowledgment

The following study was based in part on a research project conducted in London in summer 1964. Support from the Office of Research of the Schools of Business of New York University is gratefully acknowledged. The author also benefited from the critical reviews and comments of colleagues, past and present. But his greatest intellectual debt is to a large number of bankers in London, whose patience and helpfulness are as little known as their desire for anonymity has been publicized, to wit:

He was expert at dabbling in exchanges
This estimable [banker] so had set
His wits to work, none knew he was in debt.
He was stately in negotiation,
Loan, bargain and commercial obligation.
He was an excellent fellow all the same,
To tell the truth, I do not know his name.

(Geoffrey Chaucer, "Prologue" to *Canterbury Tales,* translated by Nevill Coghill.)

DR. BLOCH *is Professor of Finance in the School of Commerce of New York University. He holds a Ph.D. from the New School for Social Research. Prior to coming to New York University, Professor Bloch was an economist at the Federal Reserve Bank of New York from 1949-1962.*

In addition to articles in the American Economic Review, *the* Review of Economics and Statistics *and the* Monthly Review *of the Federal Reserve Bank of New York, Dr. Bloch authored one of the C.M.C. monographs,* The Federal Home Loan Bank System, *published in* Federal Lending Agencies, *Prentice-Hall, 1963.*

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Eurodollars: An Emerging International Money Market

I. Introduction

For the world economy today, international finance means to a very important extent dollar financing. This "vehicle-currency" role of the dollar in the world economy reflects at once the availability of dollar credits to finance just about anything anywhere, and the dollar's acceptability as a "reserve" currency to settle imbalances in international accounts. The reserve currency aspect of the dollar's role has been, and is being, amply discussed under the various proposals put forth for reforming the international monetary system.[1] The supply of dollars for international financing, on the other hand, continues to organize itself in new and interesting ways and it is to one of its lesser-known aspects, the "Eurodollar market," that this study will be devoted.

In its simplest terms, the Euro*dollar* market is an internationally established money market for United States dollars held abroad. Although some dollars had been held by foreign banks and reloaned by them in small quantities in the early 1950's, neither the size of such holdings nor the rate of transactions were of market-size dimensions until late in the decade.

Examples of the Eurodollar market's precursors mentioned by Einzig[2] are the dollar loans made by French banks to Italian banks in the early fifties and, going back into another generation, the markets in sterling and dollar deposits located in Berlin and Vienna during the period following World War I. What makes the Eurodollar market worthy of that name is its substantial size, organization, and multilateral character. Indeed, as it grew, the Eurodollar market broadened into other, parallel Eurocurrency markets such as Euro-sterling, Euro-D marks, Euro-Swiss francs, but these

1 For a broad discussion of these plans, see R. G. Hawkins and S. E. Rolfe, *A Critical Survey of Plans for International Monetary Reform*, THE BULLETIN, C. J. Devine Institute of Finance, No. 36, November 1965.

2 See Paul Einzig, *The Eurodollar System*, New York, 1964.

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are of much lesser importance; in 1965, out of an estimated volume of aggregate Euro-currency lending of about $14.5 billion, some $11.5 billion were Eurodollar loans.[3]

Eurodollar operations are similar to money-market operations anywhere: they involve principally large-scale financial institutions such as banks and other intermediaries, and corporations. Further, Eurodollar operations are typically in wholesale lots of $1 million or more, usually for short-term periods.[4] The vehicle function of the dollar thus extends beyond the confines of trade financing as such; the dollar is in addition a vehicle for international financial intermediation.[5]

How, then, does a United States dollar become a vehicle currency called a Eurodollar? Does a Eurodollar transaction differ from any other type of wholesale United States dollar transaction abroad? Yes. Is any "wholesale" dollar loan abroad a Eurodollar loan? No. A Eurodollar operation can be said to take place only when a bank abroad accepts a deposit denominated in United States dollars and relends those dollars, frequently to another bank. The special feature of this type of interbank dollar intermediation is the acceptance of dollar deposits *as such* by banks abroad.

A Eurodollar transaction—the trading of dollar liabilities—thus begins when a United States dollar demand deposit is accepted by a foreign bank as an interest-bearing time deposit. The dollar demand deposits originate from dollar balances accumulated by foreigners as a result of balance of payments deficits. On the operational level, this means that foreign holders of United States dollar deposits in United States banks may place these funds in the E$ market.[6] Another source of dollar funds arises when demand deposits owned by United States residents are placed at interest with foreign banking institutions. Both foreign and United States owners of dollar deposits shift their funds into E$ banks—called Euro-

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[3] See Bank for International Settlements, *Thirty-Fifth Annual Report*, Basle, 1965, p. 134.

[4] The use of Eurodollars to finance long-term bond offerings in Europe is not considered in this study. See Paul Einzig, *Foreign Dollar Loans in Europe*, New York, 1965, and for subsequent developments in this area, "The Squeeze on Dollar Bonds," *Economist*, January 22, 1966, p. 348.

[5] For further discussion of the dollar's function as an intermediary, see J. Tobin, "Europe and the Dollar," *Review of Economics and Statistics*, May 1964, pp. 123-26, and Despres, Kindleberger, and Salant, "The Dollar and World Liquidity," *Economist*, February 5, 1966, pp. 526-29.

[6] Hereafter, the word "Eurodollar" will be abbreviated to E$.

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banks for convenience—because the rates paid on E$ time deposits have been generally better than depositors could obtain from United States credit instruments of comparable quality and maturity. In this competition for funds, Eurobanks behave like conventional financial intermediaries in this country; the E$ market as a whole can thus be viewed as yet another layer in the process of financial intermediation within the United States economy. Indeed, it will be argued that the E$ is *par excellence* the vehicle currency through which the money market of the United States is linked with money markets in other countries.

II. The Eurodollar Lender as a Financial Intermediary

E$ deposits are accepted in the first instance by banks located in Europe, Asia, and in the United States as well; these large institutions, of course, are willing and able to repay depositors in dollars. Because of their size and importance, the Eurobanks that make the market command prime credit ratings and, as a result, E$ loans to them are not collateralized. The Eurobanks, acting as intermediaries, then relend the proceeds of their E$ takings either in the form of dollars or in the form of a foreign currency following a currency swap. The process of financial intermediation is set forth below.

CREATION AND USE OF E$ CREDITS

The process of financial intermediation through which E$ credits are created is the same as the creation of more familiar types of "near-money" such as, for example, savings and loan shares in this country. This is set forth in the three-step model, shown in Table 1.

Step 1: A foreign or United States holder of dollar demand deposits places his funds with a Eurobank. On the books of the United States commercial banking system a simple change in ownership of demand deposits is recorded: the demand deposit of

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TABLE 1. The Creation of Eurodollars

	United States Commercial Banking System		Eurobanks	
1. Shift of demand deposit to Eurobanks		$-DD^{d}$ $+DD^{e}$	+C	+E $
2. Eurodollar loan by Eurobank		$-DD^{e}$ $+DD^{d'}$	-C +EL	
3. Net (1 + 2)	no change	no change	+EL	+E $

DD = demand deposit
d = original depositor
e = Eurobank
C = "cash asset"
E$ = Eurodollars
d′ = new depositor
EL = Eurodollar loans

the original holder declines, while that of the Eurobank rises by an equivalent amount. On the books of the Eurobanks, a E$ liability is now offset by a "cash asset."

Step 2: The Eurobanks seek to make a profit on the E$ borrowed as a time deposit (at an interest cost) by acquiring an interest-bearing asset (let us call it a E$ loan) with the proceeds of the cash assets.[7] Once again, on the books of the United States banking system, there is a change in ownership of the dollar deposits reflecting the Eurobank's relending of its cash assets. Let us call these deposits of Eurobanks in the United States banks (that is, the liabilities of United States banks) "counterpart deposits."

Step 3: Netting out these transactions, we find that the domestic assets and liabilities of the United States commercial banking system, and its reserves, have undergone no decline whatever in size, although a part of the United States money supply now consists of E$ "counterpart deposits." The asset and liability structure of the Eurodollar system, on the other hand, has been enlarged by the equivalent of the E$ liability and E$ asset. The lending power of the Eurobanks has been raised solely as a result of the shift of funds on the books of United States banks.

The effect of this financial intermediation in the Eurodollar market is a familiar one: there is a shift of funds from holders of demand deposit balances in the United States to the Euro-

[7] Assume for the present that the new Eurodollar loan is in the form of United States dollars.

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banks; and there is a subsequent relending by the Eurobanks, which creates an additional supply of near-money deposits and credit. In this case then, a Eurobank is behaving exactly like a United States *nonbank* financial intermediary, albeit the credit may be placed outside this country. And in view of the fact that the output of E$ credit assets and the acceptance of near-money liabilities by Eurobanks take place because of the higher E$ rates offered, it may contribute to an increase in monetary velocity in the United States and presumably to a rise in the rate of economic activity somewhere in the world.

But Eurobanks are *banks;* if they act as pass-throughs for funds in the fashion of nonbank intermediaries, they do so as a matter of choice. This first behavior pattern—velocity-increasing intermediation—may change into a second—money-increasing banking. That is, Eurobanks may convert borrowed E$ into domestic "high-powered" money by switching the dollars into the equivalent of domestic reserve assets. "High-powered" money refers, for United States banks, to the reserve assets of the United States monetary system on which the money supply proper is based. Beyond the shores of the United States, a conversion of E$ into (local) high-powered money by individual Eurobanks may permit them to expand their loan volume much more rapidly than by a mere pass-through of E$ funds, if the central banks permit.[8]

Finally, the major Eurobanks are by their nature active participants in the world's money markets. This suggests that they will attempt to maximize the use of E$ as high-powered money. But beyond this, they are the most important lenders that finance international trade, frequently via E$ pass-throughs. Partly for this reason, the volume of non-United States trade financing by dollars has been substantial indeed.[9]

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[8] From the point of view of United States banking arrangements, the *pass-through* option is analogous to the efficient relending by city banks of the excess reserve portion of newly acquired deposits. The effect of this type of pass-through among United States commercial banks is to move the credit-multiplier closer to its theoretical maximum for the banks that are involved. The second option, in United States terms, is analogous to the mobilization of new supplies of Federal funds by city banks from the excess reserve supply of the country banks. In effect, the pass-through option of Eurobanks represents an attempt to move toward full employment of an available dollar reserve (or liquidity) base, and the reserve mobilization option represents the active seeking out of new sources of dollars for credit expansion.

[9] On the heavy volume of dollar credits used to finance foreign trade transactions among third countries see I. S. Friedman, "The International Monetary System," International Monetary Fund *Staff Papers,* July 1963, p. 233.

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ESTIMATING THE SIZE OF THE MARKET

The extended and extensive process of international financial intermediation, and shifts by Eurobanks from pass-through to credit expansion options, has made it difficult to assess the importance of E$ market *vis-à-vis* credit conditions in this country or, indeed, in any other country. Under the pass-through option, a varying volume of redepositing of E$ within and among a number of countries has tended to inflate numerical estimates of, say, aggregate E$ liabilities. On the other hand, when Eurobanks acquire reserves for credit expansion by converting E$ into local currencies, the dollars will not reappear in the E$ market as such, but will move into foreign-exchange channels. In any case, the impact of the two types of transactions on the available data is sufficiently different so as to require careful evaluation of the numbers purporting to set forth Eurodollar assets and liabilities. The Bank of England, the Bank for International Settlements (B.I.S.), and others handling E$ data have liberally studded their statistical offerings with cautionary remarks.

This point is well illustrated by the experience of the B.I.S. in preparing its own authoritative estimates of the size of the market. For March 1965, the B.I.S. put the level of gross Eurodollar positions at about $11½ billion (assets or liabilities) for commercial banks located in major countries.[10] These banks also held positions in other Eurocurrencies totaling about $3 billion.[11] Total Eurocurrency positions thus came to about $14.5 billion, including the inevitable redeposits and doublecounting. This total, boiled down by the B.I.S. through the use of "approximate" allowances and adjustments, put the size of the overall Euro*currency* market at $9 billion. Of that sum, "somewhat more" than $7 billion was estimated to be in the form of Euro*dollars*.[12]

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[10] B.I.S., *Thirty-fifth Annual Report*, Basle, 1965, p. 134. The major countries in the market are Belgium, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, and the United Kingdom.

[11] The other major Eurocurrencies are pounds sterling, Swiss francs, Deutsche marks, and Dutch florins.

[12] B.I.S., *op. cit.*, p. 135. It is revealing to compute the relationship of the Eurodollar market's *combined* assets to its *consolidated* assets to obtain what Goldsmith calls the "layering ratio" (See *Financial Intermediaries in the American Economy Since 1900*, National Bureau of Economic Research, 1958, pp. 316 ff.). For American intermediaries, Goldsmith's ratio turned out consistently to have a value of 1.1—that is, the volume of intraintermediary creditor/debtor positions

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However, mere estimates of the world's *stock* of E$ cannot help us to assess the actual importance of the *flows* of E$ funds through the complex international intermediation process just described. Suppose that a E$ deposit of one million is placed in, say, a Canadian bank which relends it to a London bank which, in turn, passes the deposit through to a Japanese bank.[13] Suppose further that this last bank sells the *dollars* to its central bank, the Bank of Japan, to use the yen proceeds as the means of raising its domestic reserves and its lending power. At the end of the intermediation process, the Bank of Japan acquired dollar assets of $1 million but so did the Canadian and British banks in the course of the process itself. Each of these intermediary banks has added an equal volume of dollar liabilities, of course, but these should not be netted out against their dollar assets. For a measure of any money supply, whether domestic or international, is necessarily derived from the liabilities side of the balance sheets of the institutions involved. If the netting principle were used in deriving the United States money supply, *i.e.*, if commercial banks liabilities were subtracted from assets, the measure of our domestic money supply would not show any demand deposits. According to Kenen's example, then, the international money supply is $3 million higher in the form of E$ liabilities. This expansion of the international money supply has been financed by a $1 million rise in our balance-of-payments deficit, that is, the rise in officially held dollars now owned by the Bank of Japan.

The United States dollar, in the guise of a E$, has become a truly international money supply. This remains the case even though the statistics describing its size are necessarily imprecise and their interpretation remains somewhat ambiguous. Some insights into the importance of the market may be obtained, nevertheless, by an analysis of the roles played by E$ as a money-market instrument (section III) and as a credit market (section IV).

(i.e., redeposits) was about 10 percent of total assets. In the Eurodollar market, on the other hand, combined data have consistently exceeded consolidated data by a ratio of 1.6 to 1.7. Small wonder, then, that quantification of that market is a difficult task.

[13] I owe this illustration to Professor Peter Kenen. See his "Discussion" to articles by Oscar Altman and Edward Bernstein in *1965 Proceedings*, American Statistical Association, Washington, D. C., 1966, p. 28.

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III. The Eurodollar Lender as Money-Creating Banker

The market for Eurodollars is made by banks. In making this market, the banks, rather than choosing to increase worldwide availability of dollar funds directly by pass-through E$ credits, may opt to improve their lending capacity for foreign transactions or home use by swapping E$ deposits into local "high-powered" money. In order to maximize long-run profits, the large New York and London banks must balance off these two options. The present section analyzes the conversion of E$ into high-powered money in these two money centers.

THE EURODOLLAR LOAN IN LONDON

As is well known, London serves as the major market place for E$ trading.[14] Perhaps not so well known is that the Eurobanks in London were pass-through institutions *par excellence* from the inception of the market until 1964; through 1963, the volume of their Eurocurrency loans held close to the volume of Eurocurrency deposits. In 1965, on the other hand, a declining volume of Eurocurrency loans relative to Eurocurrency deposits suggests that rising amounts of such deposits were being swapped into sterling assets, that is, into "high-powered" money. Let us call such swaps "London's takedown" of Eurocurrencies. The volume of such swaps in early 1965 became very substantial indeed, but contracted sharply by midyear, and returned to pre-1965 levels by September.

To estimate London's takedown of Eurocurrencies, adjustments should be made in Bank of England data (*see* Table 2). Data covering London's E$ (and other Eurocurrency) loans to the rest of the world include a number of non-E$ assets that are nevertheless denominated in dollars. These involve such items as minimum dollar balances of British banks with foreign correspondents,[15] as well as some other dollar balances of British residents that

[14] According to B.I.S. data, United Kingdom banks accounted for about 40 percent of total E$ liabilities in March 1965. *See also* Table 2 below.

[15] Many foreign banks hold balances with United States correspondents on a basis similar to that of country correspondents within this country. On this point, see letter by August Maffry to the Joint Economic Committee of Congress cited in "The Balance of Payments Statistics," *Hearings*, June 9, 1965, Part 3, Washington, D. C., 1965, p. 282.

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TABLE 2. London's Net Borrowing of Eurocurrencies, 1962-1965 (In millions of dollars* and percent)

		(1) Total Eurocurrency Deposits	(2) Total Eurocurrency Loans	(3) "Unadjusted Net Borrowing" by London (1)-(2)	(4) Column (3) "Adjusted"†	(5) London Borrowing: Ratios to Deposits (3)/(1)	(6) London Borrowing: Ratios to Deposits (4)/(1)
1962	December	2,906	2,828	78	320	3	11
1963	March	3,385	3,259	126	370	4	11
	June	3,522	3,455	67	310	2	9
	September	3,718	3,682	36	280	1	8
	December	3,584	3,553	31	270	1	8
1964	March	3,662	3,533	129	370‡	4	10‡
	June	3,973	3,690	283	520	7	13
	September	4,466	4,082	384	620	9	14
	December	4,995	4,578	417	660	8	13
1965	March	5,197	4,368	829	1,070	16	21
	June	5,006	4,444	562	800	11	16
	September	6,398	5,986	412	650	6	10

* Conversion from original pounds sterling at $2.80.

† Adjustments made by applying changes in column (3) to bench-mark level ‡ given for March 1964 in Bank of England, *Quarterly Bulletin*, June 1964, p. 106.

Source: Bank of England, *Quarterly Bulletin, passim*.

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are considered to be outside of the Eurodollar market.[16] As a result, the data on Eurodollar loans tend to be overstated. On the other hand, when these overstated loan data are subtracted from the Bank of England's estimate of Eurocurrency deposits, the residual places too small a value on the volume of British borrowing from the Eurocurrency markets.[17]

In Table 2 the two methods of quantifying the volume of such borrowings are compared. The first three columns of the table are straightforward: column 1 indicates total Eurocurrency (E$ plus Euro-D marks, Swiss francs, guilder, etc.) deposits, while column 2 shows loans; and the difference between them, which is called the "unadjusted net borrowing" of London, is shown in column 3. (Column 3 thus represents the same borrowing concept as "London's takedown" of E$ described above.) Column 4 uses the data for column 3, but adjusts them to the one available bench mark, namely, that given by the Bank of England for March 1964.[18] At that date, the Eurocurrency borrowings by the London market were estimated by the Bank at 10 percent of total Eurocurrency deposits, or $370 million. Estimates for other quarters were obtained by applying changes in the levels of "unadjusted net borrowing" by London (column 3) to the bench-mark figure.[19]

The last two columns of the table indicate clearly that, whichever estimate is used, the volume of Eurocurrency borrowing by London (as a share of E$ deposits) had begun to rise sharply by mid-1964. Consider the unadjusted data first (columns 3 and 5). The ratio of London's borrowings to deposits was held to 4 percent or less in the period through March 1964, but soared to about twice that figure in late 1964, and then redoubled to reach 16 percent of deposits in March 1965. Moreover, while in 1963 "London's take-

[16] For further discussion on this see Bank of England, *Quarterly Bulletin*, June 1964, p. 106.

[17] We use data for the entire Eurocurrency market because the Bank of England's bench-mark estimate is given in those terms. Recall, however, that Eurodollars have constituted nearly 90 percent of total London Euro*currency* deposits for the period shown in the table.

[18] Bank of England, *op. cit.*, p. 106.

[19] This procedure assumes that the level of the London banks' correspondent balances (and "other" United Kindom balances) in Eurocurrencies have undergone relatively little change over the period shown. Whether this is so in fact is not known. But the assumption seems reasonable in view of the following: (1) the opportunity cost of holding excess balances of this type is substantial, and (2) the individuals and institutions involved are too sophisticated to hold idle balances above the minimum required to conduct the financial activities involved. In this connection, note the stability of the ratio shown in the last column of Table 2 for the period prior to the bench-mark point.

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down" did recede from a (possibly seasonal) March peak, borrowings in 1964 just kept on rising through the year and into 1965 to reach an all-time peak in March 1965.

The same story is revealed by the adjusted data (columns 4 and 6). For the Bank of England's bench-mark date March 1964, the *level* of London's takedown works out to $370 million, and our own estimate peaks out at nearly $1.1 billion in March 1965. That last figure, as well as the unadjusted data, suggests that in the year ending with March 1965 London institutions bid away an increasingly large volume of Eurocurrencies from the market. By early 1965, London financial institutions as a whole had become a major borrower in Eurocurrency markets after having held their takedowns to relatively small and largely seasonal participations in earlier years. Indeed, their March borrowing so tightened the London money market that such high-grade borrowers, as the British "local authorities,"[20] were compelled to pay as much as 9 percent for funds borrowed for seven days.[21] By the end of April, however, the tightness in the market eased, and, as Table 2 shows, London's takedown of Eurodollar funds was substantially cut back in June, and lowered even further by September 1965. This cutback reflected both a rise in deposits and a rise in loans outside the London Eurobanks.

Even though the evidence suggests that the takedown of Eurocurrencies by London's financial institutions was large, we cannot measure precisely to what extent major London banking institutions swapped out of E$ into sterling-type liquidity (*i.e.*, high-powered money) to offset the credit squeeze. But the added measures taken by the Bank of England in April 1965, following the March congestion in the market, indicates that the banks were engaged in such activities, for the Bank not only resorted to direct soaking up of high-powered money by a call for special deposits[22] but, in addition, imposed an absolute 5 percent ceiling on credit expansion for the year ending April 1966. And, as noted, by Sep-

20 These borrowers are British counties and municipalities.

21 Bank of England, *Quarterly Bulletin*, June 1965, p. 112.

22 The effect of "special deposits," which must be placed with the Bank of England, is to absorb high-powered money directly. The banks were requested, further, not to offset the effect of that measure by selling investments. For further discussion, *see Ibid.*, p. 111.

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tember of 1965, such use of Eurocurrencies presumably was so sharply reduced by central bank action that the level of London's use of E$ funds once again was cut to levels obtaining prior to 1965. By the end of 1965, London was once more just an entrepôt for E$ trading.

This London Eurobank experience illustrates both the difficulty of measuring the size of the E$ market and the importance of that market as a source of money market liquidity.

EURODOLLARS IN THE NEW YORK MONEY MARKET

Just as the large London financial institutions recently found it attractive to employ Eurodollars to improve their liquidity, the large New York money-market banks have likewise improved their lending capacity by raising E$ funds. Whereas the London takedown was a rather recent phenomenon and turned out to be temporary, borrowing by New York has been continuous.

A E$ asset in New York is in every way the most profitable use of E$ from the point of view of a Eurobank in London. For technical reasons, the characteristic money-market placement involves an overnight loan in London going from Thursday to Friday. This immediately reduces the riskiness of the deal since it is for the shortest possible period. Moreover, because it is made to a United States dollar borrower, no forward cover is needed. How could this best of all possible worlds exist for E$ lenders—once a week? Why were the interest rates carried by these deposits at times so high as to exceed 11 percent? And how and why were borrowers willing to pay such high rates?

Consider the daily pattern of rates paid for E$ deposits for overnight and on call (*see* Table 3). These two sets of rates are shown in tandem for the purpose of comparing two rates of roughly similar (that is, short) maturity. The call rate has held in a very narrow range in each week because the basic rate structure of the market remained essentially stable during the periods shown. The call rate thus represents an "index" rate for the market that points

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TABLE 3. Daily Interest Rates in London on Eurodollar Overnight and Call Deposits, Selected Two-Week Periods in 1964 and 1965 (In percent)

Days	1964 March 9-20 Overnight	1964 March 9-20 Call	1964 June 8-19 Overnight	1964 June 8-19 Call	1964 September 7-18 Overnight	1964 September 7-18 Call	1964 December 7-18 Overnight	1964 December 7-18 Call	1965 March 8-19 Overnight	1965 March 8-19 Call	1965 June 7-18 Overnight	1965 June 7-18 Call
Monday	3 13/16	3 7/8	3 7/8	4	3 5/8	3 3/4	3 1/4	3 3/4	4	4 3/16	*	*
Tuesday	3 7/8	3 7/8	3 7/8	3 7/8	3 5/8	3 13/16	3 1/2	3 7/8	4 1/8	4 1/4	4 1/4	4 1/2
Wednesday	3 11/16	3 7/8	4	4	3 1/2	3 3/4	3 1/2	4	4 3/16	4 1/8	4 1/8	4 3/8
Thursday	5 1/2	3 7/8	6 1/2	4	6 3/4	3 5/8	8 1/4	3 3/4	11 1/8	4 1/4	11 1/2	4 1/2
Friday	3	3 7/8	3 1/4	3 15/16	2	3 5/8	2 1/2	3 3/4	2	4 1/4	3 1/4	4 3/8
Monday	3 7/8	3 7/8	4	4	3 1/2	3 5/8	3 1/2	3 3/4	3 7/8	4 1/8	4 1/8	4 3/8
Tuesday	3 3/4	3 3/16	3 7/8	4	3 3/8	3 5/8	3 1/2	3 3/4	3 1/2	4 1/8	4 1/8	4 1/2
Wednesday	3 11/16	3 7/8	3 3/4	3 15/16	3 3/8	3 5/8	3 1/2	3 3/4	3 1/8	4 1/8	4 1/2	4 1/2
Thursday	6	3 7/8	6 1/2	4	6 3/4	3 5/8	8 1/4	3 3/4	11	4 1/8	11 1/2	4 1/2
Friday	3	3 7/8	3	3 15/16	2 3/4	3 3/4	3 1/4	3 7/8	1 3/4	4 1/8	2 1/2	4 7/16

* No quotes available.

Source: Bank of England.

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up the intraweekly seasonals of the overnight rate. The overnight rate has undergone wide oscillations of increasing amplitude.[28]

Next, consider the typical intraweekly pattern of the volatile overnight rates on E$. During Monday-Tuesday-Wednesday, the overnight rates tend to remain rather stable and, as if to underline their similarity to the call rates, both sets of rates are frequently the same. The extreme variation of the overnight rate is exclusively a Thursday-Friday phenomenon. And if the reader allows his eye to move horizontally, following the Thursdays of either of the two-week periods shown, it is readily apparent that:

1. The Thursday rates (in boldface) have been raised so sharply that between March 1964 and June 1965 they have just about doubled, going from 5½-6 percent to 11½ percent.

2. The Thursday to Friday rate comparisons indicate progressively wider fluctuation, going from a ratio of 5.5/3 percent and 6/3 percent, or from about 2/1 in March 1964, to peak out in the neighborhood of 6/1 in March 1965, and receding slightly to about 4/1 in June 1965.

These high Thursday rates are the highest E$ rates to be found anywhere for any period—whether it be on six-month or one-year E$ loans, or even on fifteen-year E$ bonds. And finally, recall that the high Thursday rates are not a function of high risk, since these funds are placed for the shortest time only—overnight—with the large money-market banks in New York. Why, then, are these rates so high? It is because the funds are used in a very profitable way.

Even at high daily rates, London's Thursday overnight Eurodollars are a relatively cheap way for United States money market banks to finance weekend reserve positions. The T-accounts shown in Table 4 present the mechanics involved. The process is set in motion by New York Bank A, which has arranged a $10 million overnight loan of Eurodollars from a "Eurobank" in London at 3 P.M. on Thursday—that is, near closing time there, which is 10 A.M. in New York. On the books of the Eurobank there will

[28] The periods picked for the two series are by no means out of line with experience in other months or with the first week of the quarterly months shown. Since all other data on the E$ market used in this study refer to the quarterly months, the periods chosen for Table 3 appear to be appropriate.

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TABLE 4. Reserve Effects of Thursday Overnight Deposits of Eurodollars in New York

(Balance sheet changes in millions of dollars)

	Thursday		Friday		Saturday-Sunday	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Eurobank						
	DD at N.Y. Bank B −10		DD at N.Y. Bank B +10			
	Loan to N.Y. Bank A +10		Loan repaid −10			
New York Bank A						
	Clearinghouse Funds +10	Borrowed Euro$ +10	Clearinghouse Funds −10	Repay Euro$ −10	Deposit, N.Y. Fed. +10	
			Deposit, N.Y. Fed. +10			
New York Bank B						
		DD Eurobank −10	Deposit, N.Y. Fed. −10	DD Euro$ +10	Deposit, N.Y. Fed. −10	
		DD Bank A +10		DD Bank A −10		
F.R.B. New York						
				DD Bank A +10		DD Bank A 0
				DD Bank B −10		DD Bank B 0

DD = demand deposit

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be a shift in assets, reflecting the switch of "counterpart deposits" in New York to Bank A and away from Bank B, the prior repository of these funds.[24] Bank A then places the borrowed E$ deposits on *its* books in the form of clearinghouse funds on Thursday, to be presented for collection at the clearinghouse at the close of business. When the $10 million clearinghouse check is presented at the Federal Reserve Bank of New York on Friday morning, it becomes Federal funds; as a result of that set of transactions Bank A has gained a $10 million deposit at the Federal Reserve Bank at the expense of an equivalent reserve loss by Bank B. There remains just one more step for Bank A to take on Friday: it will unwind the transaction, *but only on the Eurodollar side*. Bank A pays off its E$ loan in clearinghouse funds on Friday,[25] but these funds will not be collected in the form of Federal funds until Monday because the transaction is not cleared on the books of the Federal Reserve Bank over the weekend.

The gain to New York Bank A from its high-interest bid for Thursday Eurodollars is set forth in Table 5. The first column is taken directly from Table 3 and sets forth the cost of the London Eurodollar transaction. Column 2 indicates the alternative cost of raising reserves in the Federal funds market on the Friday dates shown, and column 3 provides the cost of raising Federal funds for three days (Friday and the weekend) on the relevant dates. The difference between the two alternative costs of raising reserves (column 3 minus column 1) given in column 4 indicates the opportunity gain of borrowing Friday and weekend reserves on the Eurodollar market as opposed to the cost of straight Federal funds.

A quick glance at column 4 reveals that the gain has been sharply curtailed; the spread between columns 3 and 1 dropped steadily from 5 percentage points in early March 1964 to 4 percent in midyear 1964, and it declined further to 3¾ percent in late 1964. By early March 1965, the opportunity gain had been squeezed

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[24] To simplify the exposition, Bank B is assumed to be a New York bank; the analysis would be essentially the same if Bank B were located in another Federal Reserve District.

[25] Recall that the Thursday overnight financing was in clearinghouse funds also. For the sake of clarity, some of the offsetting bookkeeping entries (mainly in "items in process of collection" accounts) have been omitted.

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TABLE 5. Rates in London on Eurodollar Overnight Deposits and Effective Rates on Federal Funds, Selected Thursdays and Fridays, 1964-1965 (In percent)

		(1)	(2)	(3)	(4)
1964		Eurodollars, Thursdays	Federal Funds, Fridays	Federal Funds Three days -(2)x3	Opportunity Gain-(3)-(1)
March	12, 13	5 1/2	3 1/2	10 1/2	5
	19, 20	6	3 1/2	10 1/2	4 1/2
June	11, 12	6 1/2	3 1/2	10 1/2	4
	18, 19	6 1/2	3 1/2	10 1/2	4
September	10, 11	6 3/4	3 1/2	10 1/2	3 3/4
	17, 18	6 3/4	3 1/2	10 1/2	3 3/4
December	10, 11	8 1/4	4	12	3 3/4
	17, 18	8 1/4	4	12	3 3/4
1965					
March	11, 12	11 1/8	4	12	7/8
	18, 19	11	4 1/8	12 3/8	1 3/8
June	10, 11	11 1/2	4 1/8	12 3/8	7/8
	17, 18	11 1/2	4 1/8	12 3/8	7/8

Sources: Column 1, Table 3
Column 2, Federal Reserve Bank of New York

further, to less than 1 percentage point; it still held there in mid-1965. Moreover, the narrowing of the gain came primarily from the raised bids for Thursday E$ deposits, which rose by 3 percentage points between year-end 1964 (8¼ percent) and March 1965 (11½ percent).[26] The bidding for Thursday overnight funds which became more and more spirited in late 1964 and early 1965 coincided with the appearance of the "premium" bid on Federal funds in the United States and with the rise in London's use of E$ funds.[27]

The aggressive bidding by New York money-market banks for Thursday overnight deposits in London is an ingenious variant of similarly aggressive bidding in this country for balances

[26] This sharp rise in rates was also associated with general market congestion in London in March 1965.

[27] The sharpening of demand for Thursday funds led simultaneously to a surge in supply of Friday funds as the New York banks unwound their transactions in Friday clearinghouse funds. Excess demand on Thursdays led to excess supply on Fridays, thereby driving down the Friday overnight rates in early and mid-1965 to levels below those of a year earlier. (*See* Table 3.)

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at the Federal Reserve—that is, high-powered money. The more familiar techniques employed by *individual* banks in the United States to expand reserves are the broadening of correspondent networks for Federal funds, the sale of certificates of deposit, and the sale of unsecured capital notes and debentures. These techniques permit the individual bank to employ a domestic process of financial intermediation to expand its resources. The E$ market permits the banks to do the same on an international basis—most profitably once a week.

To be sure, the process of competitive bidding for reserves cannot increase the system's total volume of reserves or credit or money supply beyond the levels desired by the central bank. The bidding for reserves reflects interfirm competition in money-market banking. The competition is likely to become more aggressive as central bank action tightens the money market if only because such tightening slows down any rise in the supply of available reserves facing a more rapidly rising volume of loan demand. The boost to interest rates associated with that process tends to reinforce the same result. Through 1964 and 1965, therefore, competitive forces in the bidding for bank reserves may have induced more and more banks to bid for Thursday overnight funds if *only not to lose their reserves to others.*[28]

Indeed, evidence of competition became more and more apparent as United States loan demand began its sharp rise in early 1965. This compulsion to compete (a defense mechanism of more and more banks) bid up the cost of Thursday Eurodollars to the point where, within about one year, the profit spread (shown in the last column of Table 5) had been cut back from 5 percentage points to less than 1 percent. Thus it was that the innovators' "monopoly profits" have been competed away. Does this mean that in the face of reduced profit margins the volume of Thursday-Friday operations has receded in importance? Some market participants

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[28] Following the same principle, banks attempting to sell their C.D.'s to nonbank investors will try to avoid placing them with their own depositors so as to maximize the reserve gain. Similarly, New York Bank A in our example would not be pleased to pay 11 percent to a Eurobank in order to bid for deposits already carried on its own books and that could not, therefore, become a net addition to weekend Federal funds. This problem is generally dealt with by working through a money broker in London who will make it his business to see that each transaction generates new Federal funds.

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have suggested this. Others have argued, perhaps more cogently, that rather than becoming less competitive, the aggressive bidding for E$-type reserves now takes place not only for weekend funds but throughout the week if only to prevent the loss of reserves by the individual money-market bank. The E$ market serves importantly as the vehicle through which a closer contact between the New York and London rates on high-powered money is maintained.

IV. Competition in Lending Eurodollars

Sections II and III have sought to explain the use of E$ funds by Eurobanks. It was indicated that Eurobanks use E$ funds to help themselves by generating added liquidity. Aside from that search for the raw material of banking, namely, high-powered money, banks also must concern themselves with the output side of their business, that is, the making of loans. As noted above, the Eurobanks tend to compete with one another in attracting E$ funds; Eurobanks also compete in offering credit. This competition has led to a leveling tendency in the rate structures of the money markets involved and for the customers served there. This type of competition, as the first part of this section will indicate, may lead to the breakup of some traditional interest-rate relationships in some countries and to some conflicts among lender-participants. Secondly, there is also conflict between the Eurobanks as lenders and their large customers. Because most of these prime borrowers do business in many countries, they can shop on a worldwide basis for the cheapest credit and best terms. Further, these firms, as illustrated by a case study in the second part of the section, are not reticent in exercising their bargaining power.

COMPETITION IN THE EURODOLLAR MARKET: LENDER AGAINST LENDER

Liquidity, like charity, begins at home, and the pressures of tight money have induced Eurobanks on both sides of the Atlantic to improve cash positions by E$ borrowing. These banks, and their prime customers thus enjoyed low opportunity costs on borrowed

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funds since E$ rates have been among the cheapest obtainable worldwide. As a consequence, something close to a two-tier rate structure has tended to develop in many money markets, with E$ rates offering a real threat to the maintenance of higher rate structures domestically.

The process of leveling terms and interest rates (for the best risks) throughout the world's major money markets was furthered by the policies of some central banks in Western Europe, particularly the German Central Bank. Since 1958, the Bundesbank has engaged in a type of open-market operation with its member banks in which the latter were encouraged to hold liquid assets in dollars rather than in domestic currency.[29] The Bank of Italy, likewise, has on occasion executed similar dollar-type "open-market operations." The purpose of these central bank actions was clearly a *domestic* one; the member banks were encouraged to hold dollars because further conversions into local currencies would have added funds to a banking system whose internal liquidity was deemed sufficient, and potentially excessive, by the central bank.[30]

To the extent that commercial banks responded to official inducements, they supplied funds to the Eurocurrency market. From that point, it was but a short second step for German banks to place occasional local surpluses into Eurocurrencies. Conversely, the same banks tended to borrow Eurocurrency funds to meet unexpected credit needs. The availability of the Eurocurrency market (and the Bundesbank's foreign-exchange policies) thus set in motion international flows of funds that gave rise to new competitive forces not felt in previously isolated local credit markets.

The Economist's 1964 survey on "International Banking"[31] refers to some German banks who resented "poaching" in

[29] The "encouragement" here is in the form of a preferential swap arrangement, which makes it more profitable for the German commercial bank to hold liquid dollar assets than liquid D-mark assets. This policy followed an attempt by Germany to engage in more orthodox methods of credit restriction, notably by raising interest rates in 1960. The result of that rate rise, however, was the reverse of the policy's intent, since the inflow of foreign funds in response to the higher rates increased aggregate availability of loanable funds.

[30] This is not to say that such central bank operations may not also have other goals, such as stabilization of foreign exchange rates. For further discussion, see A. I. Bloomfield "Official Intervention in the Forward Exchange Market: Some Recent Experience," *Banca Nazionale Del Lavoro, Quarterly Review*, March 1964; and testimony of Peter Fousek in *The Balance of Payments Statistics*, Hearings before Joint Economic Committee, 89th Congress, 1st Session, part 3, June 1965, pp. 250-58.

[31] See *Supplement*, November 21, 1964.

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their credit market by branches of foreign banks that obtained money-market funds in Germany at the interbank rate of 5 percent, and relent these to German borrowers "at well below the agreed 7 percent that German banks charge their customers." In Belgium, on the other hand, the branches of French banks competed for corporate deposits "by bidding above the rate generally agreed among Belgian banks." Rate competition for funds, reportedly, made a Belgian banker "really angry when I offered to break the rate agreement and then found I didn't get the deposit anyway, because another bank had broken it even more flagrantly." In Canada, likewise, the attempt to attract a sharply rising volume of deposits on the part of the Chartered Banks led them to offer better rates on E$ deposits than on Canadian dollar deposits.[32]

The extent to which the Eurocurrency markets press against established rate structures may even influence the *effective* rates on credits in the United States. For example, an American oil company may expect competitive offers of credit for one of its subsidiaries in Western Europe from branch offices of United States banks anxious to retain the parent firm as a customer. Indeed, such an offer of E$ funds to the oil company subsidiary would probably carry a contract interest rate comparable to the prime loan rate of the parent, in part because the United States parent may guarantee that loan. The *effective* loan rate to the subsidiary would be equal to the E$ contract rate, however, because compensating balances are generally not required in that market.

How can the subsidiary avoid a compensating balance requirement in a United States bank's branch abroad that even its parent must satisfy at home? The contract rate offered to the subsidiary reflects the additional competitive offers of E$ credits *without* compensating balances from domestic banks in the foreign country as well as from other foreign Eurobanks with branches in the host country. When E$ money is relatively easy, and there is strong competition among Eurobanks for the custom of prime borrowers, these borrowers get the best of both worlds: they enjoy the low

[32] See Oscar Altman, "Canadian Markets for U.S. Dollars" in *Factors Affecting the United States Balance of Payments*, Joint Economic Committee of Congress, 2d Session, Washington, D. C., 1962, p. 536.

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interest rates of the new world while benefiting simultaneously from the old world's custom of loans without balance requirements.

THREE-MONTH DOLLAR CREDIT ARRANGEMENTS IN LONDON MERCHANT BANKS: LENDER AGAINST BORROWER

The downward pressure on credit costs associated with the expansion of the Eurocurrency market is also illustrated by a significant change in the pattern of lending of one major group of Eurobanks — the merchant banks in London who are important financiers of foreign trade as well as major intermediaries in London's Eurodollar market.

Traditionally, the bulk of foreign-trade financing in London has been done by the merchant banks, through acceptance financing.[33] The major share of London's acceptance financing has been done by the "accepting houses," a subgroup of merchant banks.[34] A number of merchant bankers in London suggested (in discussions with the author in 1964) that the availability of E$ financing put pressure on acceptances, and that since 1962 the commission charged to prime borrowers in particular had been squeezed. The pressure placed on the accepting fee charged by merchant banks has had the effect of further segmenting the acceptance market: borrowers who can qualify for E$ accommodation will, by virtue of their low-cost alternative, be able to enjoy the cheapest acceptance fee. In discussion with officers of major accepting houses in London, the writer found that to prime risks the acceptance commissions were first shaded to 1¼ percent in 1962 and lowered further to 1 percent in May 1964.[35]

[33] A bankers' acceptance is evidence of a trade debt (or a "commercial bill") that has been "accepted" by a financial institution such as a bank. Such an "acceptance" means that the bank's credit stands behind the credit of the debtor should the resources of the latter be insufficient at the maturity date of acceptance.

[34] There are a sizable number of institutions in London going by the name of merchant banks, but the seventeen most important among them (in the acceptance business and otherwise) form the group called "accepting houses." These institutions have financed about 50 percent of total acceptance financing undertaken by all those institutions that also lend Eurodollars in London. For further discussion, see R. S. Sayers, *Modern Banking*, 6th ed., London, 1964, p. 51 ff.

[35] This should not be taken to mean that *all* acceptance commissions came under pressure. In summer 1964, many acceptance borrowers paid 1½ percent commission and some were charged as much as 2 percent.

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TABLE 6. Computation of Competitive Borrowing Costs of Ninety-Day Dollar Loans in London, End of Quarters,* 1964 and 1965 (In percent)

ITEM	1964				1965	
	March	June	September	December	March	June
1. Cost of Acceptance to Best Risks:						
a) Base rate (prime bank bills)	4 1/2	4 5/8	4 13/16	6 13/16	6 13/16	5 15/16
Plus: *b)* Acceptance commission	1	1	1	1	1	1
Equals: *c)* Gross cost	5 1/2	5 5/8	5 13/16	7 13/16	7 13/16	6 15/16
Subtract: *d)* Premium on forward dollar	1/2	3/8	9/16	1 15/16	2 1/16	1 4/16
Equals: *e)* Net cost	5	5 1/4	5 1/4	5 7/8	5 3/4	5 11/16
2. Cost of Eurodollar loan to Best Risks:						
f) Cost to bank (E$ deposit rate)	4 1/4	4 3/8	4 1/2	4 7/8†	4 7/8	4 15/16
Add: *g)* Net deposit/loan spread charged to borrower (set by market)	3/8	3/8	3/8	3/8	3/8	3/8
Equals: *h)* Net cost	4 5/8	4 3/4	4 7/8	5 1/4	5 1/4	5 5/16
3. Advantage in favor of Eurodollar loan: *(e)* – *(h)* =	3/8%	1/2%	3/8%	5/8%	1/2%	3/8%

* Rates as of last working day of quarter with exception noted below.

† For technical reasons, the year-end rate on E$ deposits seemed unusually low. The rate of 4¾-⅞, which prevailed for most of the month, was used instead.

Sources: Items *a, d, f,* Bank of England, *Quarterly Bulletin, passim.* All other items based on survey conducted by author in London merchant banks and money brokers in summer 1964.

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The narrowing of the acceptance commission cost and its relationship to the cost of Eurodollar financing is revealed by the data presented in Table 6. The "net cost" of acceptance financing (item "e") consists of the base rate on prime bank bills, the acceptance commission, and the adjustment that must be made for the swap into forward dollars.[36] The cost of E$ loans to these same risks is the (borrowing) rate paid by London banks on three-month E$ deposits (as shown by the Bank of England's *Quarterly Bulletin*) plus a rate increment, or loan spread, charged to the prime-quality E$ borrower. That increment was about ⅜ percent in mid-1964; it has been held at that level through this exercise even though the play of lender/borrower competition might have narrowed it somewhat.[37] The table shows clearly that the advantage in favor of the E$ loan has held at a rather steady level, in the neighborhood of ½ point, give or take ⅛ percent. Or, to put it another way, the profit/risk-equilibrium for the merchant banks apparently involved the maintenance of a ½ point difference of total credit costs for prime risks between acceptance financing on the one hand, and the competitive rate on E$ accommodation on the other.

Given the progressive reduction of acceptance commissions by the 17 major merchant banks since 1962, the question now arises whether this policy added to their acceptance volume. The answer is not much, if at all. From a level of about $½ billion equivalent at year-end 1961, acceptances outstanding rose but slowly to about $520 million in the year following and drifted up to the neighborhood of $550 million during the period 1963 to September 1964. At best, this slow growth suggests that the shading of acceptance commissions was helpful in offsetting the vigorous rate competition from generally cheaper E$ credits (*see* Table 6). Moreover, during the same 1962-1964 period, the volume of nonacceptance financing of the seventeen accepting houses rose quite sharply indeed, dou-

[36] The cost of forward cover into dollars must be added to acceptance financing since that financing is in sterling. Only on that basis does acceptance financing become comparable to Eurodollar financing. Of course, swaps into other currencies would carry different rates, and arbitrage swaps through low-interest rate currencies might turn out even cheaper than with E$. But this aspect of foreign exchange/Eurocurrency markets cannot be treated in this study.

[37] On the other hand, for relatively large, or otherwise unusual financing, even the best risks might be charged a somewhat higher spread. Such individual variations did not, however, significantly affect the estimate of the average spread.

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bling from about $1½ billion to more than $3 billion while, as noted, the volume of outstanding acceptances barely moved.[38] Moreover, among the growing assets of these banks, the category of "advances" (which includes E$ credits) rose most rapidly.

While E$ financing was much cheaper to the prime borrowers, it was by the same token probably less profitable to the merchant banks. At best, the profit to be made on E$ loans came to the deposit/loan spread of ⅜ percent. For the same set of borrowers, carrying an admittedly small risk, the acceptance commission worked out to a full 1 percent, even after February 1964.[39] And, yet, the (more profitable) acceptance business barely held its own until late 1964 just because the prime borrowers had their choice of E$ lenders in London and *elsewhere* up to that time.

Since September 1964, however, the volume of acceptance financing has increased very sharply. From a September level of about $550 million, it rose to $650 million in December 1964, and to $700 million in March 1965. Table 6 demonstrates that a cheapening of acceptance costs did not play a significant role in the recent switch back to acceptance financing. Rather the explanation lies on the side of availability — or more precisely, lack of availability—of E$ funds. Beginning with the credit squeeze of late 1964, the institutions in the London money market attempted to improve their own liquidity by "borrowing" E$ for their own accounts. This withdrawal of E$ funds, as noted in III above, brought on a shortage of funds — and a steep rise in rates — in the local-authority market in March 1965. In addition, other demands for funds that previously had been accommodated with cheaper E$ were now driven back to the old standby, acceptance financing, in a typical response to the impact of tighter money.

In sum, the pattern of financing even *within* London money-market institutions has undergone significant changes owing to variations in the supply of and demand for funds going into the E$ market. New patterns of lender-borrower relationships remain sub-

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[38] Based on asset data presented in the *Quarterly Bulletin* of the Bank of England for Accepting Houses.

[39] This comparison tends to understate the relative profitability of the acceptance business because that type of paper only constitutes a contingent liability, whereas the E$ deposits accepted constitute a direct liability and the E$ loans a risk asset of the merchant banks.

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ject to monetary pressures as the experience of late 1964 and early 1965 amply illustrates. What the E$ market has done is to bring about a greater degree of interaction and interdependence among the world's several financial markets. This is not to say that local monetary authorities have lost any part of their control in the area of availability of credit. Governmental moves toward more direct control over foreign lending, such as this country's Voluntary Credit Restraint Program, have further increased the power of monetary authorities by adding controls over the direction of the international flows of loanable funds. Nevertheless, the development of the E$ market has, in a sense, called forth some of these more recent policies for control because of the multinational character of financial intermediation that that market makes possible.

V. Concluding Remarks

The Eurodollar market has been called an *emerging* money market in this monograph because it continues to develop in the face of new problems. But however the market appears to have changed, it continues to influence interest rates and credit availability in most money markets, and in new and unexpected ways. Is the market here to stay? How will it continue to develop? And, finally, will it continue to have a reason for existence if the problems of United States balance of payments adjustment and of international liquidity are institutionalized, even if not solved?

Although the conditions under which the E$ market would disappear include the "solution" of this country's balance-of-payments problem as a necessary condition, the sufficient condition would be an integration of the world's major financial markets. If Europe moves toward more efficient and freer capital markets while the United States reverses its 1963-1966 moves toward more restrictive policies, interest rates may move toward an (internationally) equal level. The need for organizing a separate and specialized money submarket within the international money market would then disappear. But in the absence of closer integration of world money markets, and the elimination of market segmentation

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in some European countries, the conditions that gave rise to the E$ market will remain, and the market may even continue to grow.

This favorable prognosis for the E$ market at the present time assumes that controls on United States short-term capital outflows are not substantially intensified, and that the United States money market maintains its superior degree of integration and efficiency. On the other hand, intensification of discrimination by the United States against short-term foreign investments in the form of direct controls, discriminatory taxation, or "voluntary restraints" may well dry up some major sources of supply of Eurodollars, thereby compressing the market or reducing its efficiency by forcing it to rely more heavily on other Eurocurrencies. In any case, it will be interesting to review market developments following a full twelve months of the voluntary restraints program on United States nonfinancial corporations and the reduction in United States corporate and bank liquidity.

Barring a severe contraction of international credit availability, the Eurodollar market will continue to be a major tie between various money markets. It will continue to serve as a "financial intermediary," providing the major alternative means of finance to domestic sources of funds for prime borrowers all over the world. In addition, it will also serve as a "money creator" providing commercial liquidity for banks through monetization of E$s during periods of tight credit. Whether serving as a source of credit or as a standard form of secondary reserves for foreign banking systems, the Eurodollar has a useful role to play in a world of imperfect money markets. We conclude that in the absence of a full-fledged international money market that exists without policy frontiers, and as long as the United States dollar supply continues to be more readily available and cheaper than other currencies, domestically as well as internationally, the E$ market has a good chance to survive—and even to thrive.

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The following is a selection from the Eurodollar studies that have appeared since 1960. The Holmes-Klopstock and Altman studies were among the first to call attention to the market, as was *The Economist,* which continues to keep it under review. Up-to-date statistics on the market may be obtained from the Bank of England's *Quarterly Bulletin;* the reviews of the market in the *Annual Reports* of the Bank for International Settlements and the International Monetary Fund present valuable information on current developments.

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Report of the Committee

on

FINANCIAL INSTITUTIONS

to the

PRESIDENT OF THE UNITED STATES

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THE WHITE HOUSE,
Washington, April 19, 1963.

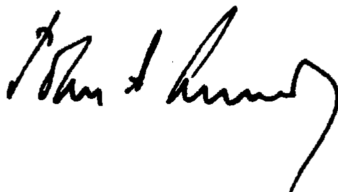
MEMORANDUM FOR MR. WALTER W. HELLER, Chairman, Council of Economic Advisers.

Subject: Report of the Committee on Financial Institutions.

I should like to express my appreciation to you, as Chairman, and to the members of the Committee on Financial Institutions, for the valuable analysis you have made of the changes in Government policy toward private financial institutions, which could contribute to economic stability, growth, and efficiency. It is heartening that the eleven agencies represented, all of them intimately involved in the formulation and execution of Federal policies affecting such institutions, both recognize the need for improvements and agree on the steps which should be taken.

The conclusions of the Committee are couched in terms of principles and goals. As the Report states, many of the needed revisions in law and policy identified by the Committee are not so urgent as to command the highest priority. However, in my judgment, they will provide a sound basis for policy and constructive guidance in considering specific proposals for legislative action.

It is important that we begin to take the actions necessary to strengthen and make more effective our private financial system. For instance, Federal insurance for bank deposits and savings and loan share accounts has long proved its value. The problem of additional coverage is now before the Congress. The report concludes, and I agree, that in increasing the coverage of deposit and share insurance certain related issues should be satisfactorily resolved. I am requesting that draft legislation resolving these issues be prepared as soon as possible.



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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., April 9, 1963.

DEAR MR. PRESIDENT: I submit herewith the Report of the Committee on Financial Institutions, established in response to your memorandum of March 28, 1962. The members of the Committee are listed in the letter of transmittal which follows.

This report is the product of an immense amount of effort by members of the Committee and their staffs. The Committee held 39 formal meetings, at which it considered a broad range of issues, many of them controversial. It had the benefit of close to 100 working papers prepared by the various departments and agencies; numerous studies and memoranda prepared by trade associations, financial institutions, and individuals; and the report and studies of the Commission on Money and Credit.

James Tobin, member of the Council of Economic Advisers, acted as Chairman pro tem of the Committee until July. Since that time, Gardner Ackley, Mr. Tobin's successor on the Council, has served in this capacity. The Committee is extremely grateful to Robert Solomon of the staff of the Board of Governors of the Federal Reserve System, who ably served as its Secretary and as the principal draftsman of its report, as well as to Chairman Martin for making Mr. Solomon's services available to the Committee.

Your charge to the Committee was that it "consider what changes, if any, in Government policy toward private financial institutions could contribute to economic stability, growth, and efficiency." While the Committee has not attempted to formulate specific legislative recommendations, its findings point to a number of significant changes in legislation and in administrative rules and arrangements that would enable private financial institutions to play a more effective role in our market economy.

Although numerous improvements are suggested, the report as a whole offers reassurance that our financial system, for the most part, functions soundly and efficiently to promote the growth and stability of our economy and effective employment of our Nation's savings; and that Federal supervision and regulation advance these ends. The Nation is therefore in a position to proceed with improvements after

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due deliberation rather than, as has so often been true in the past, under the pressure of financial crisis.

All members approached these difficult and controversial issues in a spirit of cooperation and with a sincere desire to obtain the maximum possible degree of consensus. As a result, a majority of the Committee's specific conclusions were reached by unanimous vote. On the others, there were one or more dissents. Even where there were no dissents, however, the conclusions frequently represent a "common denominator" of somewhat differing shades of opinion.

The Committee unanimously recommends that this report be released for publication. In addition to the guidance which the report may provide for the executive and legislative branches of the Federal Government, we believe that the report's analysis of issues and its findings can contribute to a better understanding of these complex questions in the financial community and in the public generally.

Respectfully,

WALTER W. HELLER, *Chairman.*

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LETTER OF TRANSMITTAL

APRIL 10, 1963.

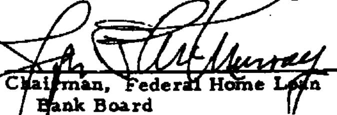
DEAR MR. PRESIDENT: Attached is the report of your Committee on Financial Institutions, which you appointed on March 28, 1962, "to review legislation and administrative practices relating to the operations of financial intermediaries," and "to consider what changes, if any, in government policy toward private financial institutions could contribute to economic stability, growth, and efficiency."

Faithfully yours,

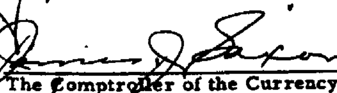
Secretary of the Treasury

Secretary of Agriculture

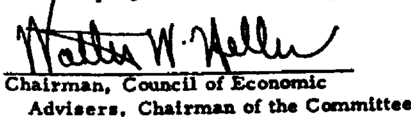
Director, Bureau of the Budget



Chairman, Federal Home Loan Bank Board

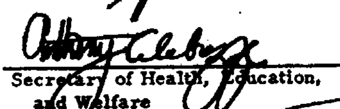


The Comptroller of the Currency

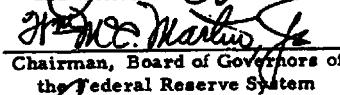


Chairman, Council of Economic Advisers, Chairman of the Committee

The Attorney General



Secretary of Health, Education, and Welfare



Chairman, Board of Governors of the Federal Reserve System

Administrator, Housing and Home Finance Agency

Chairman, Federal Deposit Insurance Corporation

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REPORT ON FINANCIAL INSTITUTIONS

Chapter I

INTRODUCTION

The general task of the Committee on Financial Institutions was, according to the President's memorandum establishing the Committee, "to consider what changes, if any, in governmental policy toward private financial institutions could contribute to economic stability, growth, and efficiency."

Private financial institutions serve a vital function in the economic process. They gather funds of economic units with surpluses and lend funds to economic units with deficits. In addition, commercial banks, the largest group of private financial institutions, create the bulk of the economy's medium of exchange and administer its payments mechanism, and are the main channel through which monetary and credit policy is implemented. These institutions as a group are closely involved in financing capital expenditures and in creating liquid assets for businesses and consumers. As a result, the activities of financial institutions have an important bearing on economic growth and on fluctuations in economic activity. As lenders of capital, financial institutions also influence the allocation of resources and therefore the efficiency with which the economy operates. Although the financial system by itself cannot assure that the economy will enjoy steady, stable, and efficient growth, a well-functioning financial system is a necessary condition for stability, growth, and efficiency.

Only on a few occasions in our history has the Government undertaken a broad examination of the financial structure in the absence of a crisis that made such an examination imperative. During the Civil War, after the financial panic of 1907, and during the Great Depression, the need for reexamination and action with respect to the financial structure was unmistakable.

The occasion for the present study was quite different. It was triggered not by a crisis, nor by the presence of acute problems. Rather, it represented a recognition that substantial changes had occurred in our economy and in the financial structure since the mid-1930's. In the decade of the Great Depression, numerous innovations had been introduced into the relationship between Government and private

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financial institutions. Many of these changes were designed either to prevent a repetition of the financial catastrophe of the early 1930's or to encourage recovery from severe depression.

Since World War II, the economy has grown and the environment in which financial institutions operate, and which they help to create has altered appreciably. The question naturally arose whether these changes called for new approaches or revisions in Federal regulation in the financial area.

In the interim, there were a number of congressional investigations in the area of financial institutions. Subcommittees of the Joint Economic Committee under Senator Douglas (1950) and Representative Patman (1952) made intensive studies of monetary, fiscal, and debt management policies and in 1956–57 the Senate Banking and Currency Committee under Senator Robertson reviewed Federal laws applicable to financial institutions.

More recently, the Commission on Money and Credit, a private group, undertook an extensive study and in 1961 presented a set of recommendations calling for, among other things, reform and improvement of the financial structure.

The present Committee's assigned task was to take the recommendations of the Commission on Money and Credit as a point of departure and to determine what changes, if any, are desirable in the Federal Government's approach to private financial institutions in order to contribute to economic growth and stability, remove apparent inconsistencies, inequities, and impediments in the financial structure, and assure that other public purposes are being served effectively.

The Committee was established at the end of March 1962. The large number of issues requiring examination in the period since then precluded any sizable amount of new research. The Committee's analyses have been based largely upon existing information and studies (including those done for the Commission on Money and Credit) and the experience of its members and staff, together with written submissions from interested groups and individuals outside the Federal Government.

On this basis, the Committee has weighed the various issues within its terms of reference and has arrived at conclusions, not always unanimous, regarding goals and objectives of Federal policy with respect to private financial institutions. The Committee has generally refrained from formulating specific legislative recommendations. Its conclusions are generally stated in broad terms rather than in the form of detailed proposals.

Implementation of many of the conclusions in this report would require transitional arrangements. The Committee has not attempted

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to spell out the details of such arrangements, which would depend on the circumstances at the time of implementation.

Our study points to needed improvements in the financial structure. If implemented by legislation, these reforms would contribute in various ways to a better functioning economy. The indicated changes are not so compelling as to command the highest priority in the President's legislative program. But it is of the essence of good government to attempt to anticipate problems before they become acute. In the financial area particularly, where public confidence is crucial to the continued effectiveness of the financial system, and indeed to economic stability generally, it would be unfortunate to confuse lack of urgency with lack of importance. Problems should be dealt with as they become evident in order to avoid the need for urgent action to meet a crisis situation. Furthermore, insofar as unwise policies, inconsistencies, and inequities creep into the financial system, they are more difficult to remove the longer they are tolerated, either because groups come to depend on them for their livelihood or because some policies are not reversible.

Scope of Study

The Committee's terms of reference, as set out in the President's memorandum of March 28, 1962, cover Federal laws and regulations pertaining mainly to private institutions that accept deposits and shares. The Federal Government is involved with these institutions in numerous capacities: as monetary authority seeking to encourage economic growth and stability, as chartering authority, as insuring authority, as lending authority, and as general supervisory authority concerned with financial soundness, preservation of competition, and provision of adequate services to the public. These governmental functions naturally impinge upon each other and overlap in various ways. As a result, judgments regarding Federal policies with respect to private financial institutions must rest on a balancing among several criteria, which sometimes point in different directions.

In conducting its study and formulating its judgments, the Committee has been guided by five basic criteria. Not necessarily in order of importance, these are as follows:

1. *Strengthening the effectiveness of Government stabilization policies in the financial area.* Nearly every issue to which the Committee addressed itself had implications for monetary policy.

2. *Increasing the effectiveness of lending institutions in contributing to efficient resource allocation and promoting economic growth.* Governmental regulations and restrictions need to be examined from time to time to assure that they enhance rather than limit the ability of

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private financial institutions to respond to the needs of a growing and changing economy.

3. *Improving equity and efficiency in the regulatory or statutory treatment of financial institutions.* Governmental supervision and regulation can impose competitive advantages or disadvantages on one or another group of private financial institutions. Equally possible is the development of inconsistent or inefficient supervisory actions and policies. It was an objective of the Committee to examine existing regulations and, where appropriate, to recommend elimination of apparent inequities or inefficiencies.

4. *Preserving the solvency and liquidity of private financial institutions so as to protect the savings of the public.* Although it was alert to the need for flexibility and improvement in the financial system, the Committee was continuously conscious of the importance of traditional safeguards over the solvency and liquidity of financial institutions.

5. *Strengthening competition among financial institutions.* Government supervision involves limitations on the scope of competition among financial institutions, because unrestricted competition in the financial area can lead to failures which have wide repercussions, well beyond the welfare of those who own or manage the individual institutions involved. Nevertheless, competition is relied upon to promote efficiency and to protect the public. The Committee was concerned with promoting competition among financial institutions where consistent with other important objectives.

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Chapter II

SCOPE AND STRUCTURE OF RESERVE REQUIREMENTS

Reserve requirements were originally regarded as a means of assuring that banks maintain sufficient liquidity to meet possible withdrawals of deposits. In present circumstances, it is generally agreed that required reserves serve only a marginal liquidity function; for example, with a 15-percent reserve requirement, a bank would have to meet 85 percent of a deposit withdrawal by reducing assets other than its required reserves. The major function of required reserves, it has come to be recognized, is to facilitate monetary policy. Required reserves perform this function by providing a firm base or fulcrum by means of which actions of the central bank to expand or contract commercial bank reserves are transmitted so as to bring about multiple increases or decreases in bank credit and deposits.

Although their primary function is to serve as a fulcrum for monetary policy, reserve requirements have other effects which are pertinent to policy judgments about the structure and level of requirements. Reserve requirements affect the earning power of banks (or other financial institutions subject to reserve requirements), since these requirements determine the proportion of bank assets that must be held in the form of cash.

A closely related effect of reserve requirements is on the competitive relationships among different types of financial institutions and on their relative rates of growth. The ability to offer terms attractive to savers is influenced by the amount and form of reserves, if any, that financial institutions are required to maintain. This consideration arises most directly in connection with the reserve requirement on commercial bank time and savings deposits, which are closely competitive with savings accounts available at mutual savings banks, savings and loan associations, and credit unions; it may also affect the ability of individual banks to attract and hold demand deposits.

Also related to the influence of reserve requirements on bank earnings is an effect on net interest payments by the Federal Government. The level of reserve requirements influences the distribution of holdings of Government securities between the Federal Reserve and the public. If, for example, reserve requirements are relatively high, the Federal Reserve will necessarily purchase in the open market larger

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amounts of U.S. Government securities to provide for a desired increase in the volume of deposits and bank credit. Thus the Federal Reserve, whose earnings revert largely to the U.S. Treasury, will tend to hold a larger proportion, and the public, including commercial banks, will hold a smaller proportion of outstanding United States Government securities.

Major problems concerning reserve requirements.—The questions to which the Committee addressed itself include (1) whether any or all commercial banks should be required to be members of the Federal Reserve System, (2) whether all commercial banks should be subject to the reserve requirements of the Federal Reserve, (3) whether the structure of reserve requirements on demand deposits could be improved, (4) whether reserve requirements on commercial bank time and savings deposits should be retained, and (5), if so, whether a similar requirement should be applied to savings accounts at other financial institutions.

Federal Reserve Membership and/or Reserves

Under existing law, membership of commercial banks in the Federal Reserve System is mandatory for national banks and voluntary for State-chartered banks. National banks comprise one-third of all commercial banks and hold somewhat more than half of all commercial bank deposits. About 18 percent of State-chartered banks presently choose to belong to the Federal Reserve System. They account for about two-thirds of the deposits of all State banks.

Taking all commercial banks together, more than 7,000 (55 percent of the total) are not members of the Federal Reserve System. But they hold only about 16 percent of deposits at all commercial banks.

History of problem.—Whether or not all commercial banks should be members of the Federal Reserve System or subject to its reserve requirements has been the object of numerous studies and recommendations over the years.

The principle of voluntary membership for State-chartered banks was first called into question by the Banking Act of 1933, which provided that, in order to enjoy the benefits of deposit insurance, State banks would have to become members of the Federal Reserve System by July 1, 1936. The Banking Act of 1935 exempted banks with deposits of less than $1 million from this provision. The deadline was postponed from time to time, and in 1939 the provision was repealed.

In the postwar period, both the Douglas (1950) and Patman (1952) committees (subcommittees of the Joint Economic Committee making studies of monetary and credit policies) recommended that all commercial banks be made subject to the reserve requirements of the Fed-

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eral Reserve and that all banks be given access to loans at the Federal Reserve banks.

Most recently, the Commission on Money and Credit recommended that all insured commercial banks be required to become members of the Federal Reserve System.

Principal issues.—The case for and against compulsory membership of commercial banks in the Federal Reserve System rests on the questions of (1) the effectiveness of monetary policy and (2) equitable treatment of competing banks. In both questions, the compulsory reserve requirement involved in Federal Reserve membership is the primary issue.

Effective monetary management.—As noted, it is now generally recognized that the major purpose of legally required reserves is to serve as a fulcrum for monetary policy. Member bank reserves function as a fulcrum for monetary policy for two reasons: (1) for each member bank, deposits may not exceed a given multiple of its reserves, and (2) the total supply of these reserves is under the control of the Federal Reserve System. Thus even in the absence of changes in the required ratio of reserves to deposits, alterations in the supply of reserves made available to member banks by the Federal Reserve, for example by open market operations, normally lead to more or less predictable alterations in the aggregate deposits and assets of member banks. In addition, the Federal Reserve can affect bank deposits and assets by changing the required ratio of reserves to deposits.

In present circumstances, nonmember banks are subject to a variety of State laws regarding legal reserves. These reserves may consist of deposits in other commercial banks, or, in some States, approved types of securities, as well as vault cash. Thus, the position of nonmember banks differs from that of member banks in that neither their reserve ratio nor the supply of reserves on which they draw is uniquely determined by the Federal Reserve.

The result is that Federal Reserve directly influences only that portion of the money supply held in member banks. Yet deposits in nonmember banks are no less a part of the money supply of the United States. As a result, there is some possibility of slippage in the effectiveness of monetary policy.

The Committee believes that, in current circumstances, monetary policy is not significantly weakened by the fact that commercial banks now holding 16 percent of total deposits are outside the direct influence of the Federal Reserve. Important short-run disparities in deposit expansion have not occurred nor are they likely to occur so long as nonmember banks account for a relatively small fraction of deposits. Attempts by nonmember banks to expand credit at a faster

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pace than they can attract funds from depositors would promptly result in an unsustainable cash drain, and their ability to attract deposits depends on their overall competitive position which is not likely to change significantly over different phases of the business cycle. Over longer periods, however, there is some evidence that the rate of growth of deposits has been larger in nonmember than in member banks. Their lighter burden of required reserves could permit nonmember banks to offer more attractive terms to depositors and thus to outgrow member banks.

Potentially, a more important consideration bearing on the effectiveness of monetary policy is that the option open to State banks to withdraw from the Federal Reserve System can at times constitute a constraint on actions by the Federal Reserve. In the early post-World War II years, when increases in reserve requirements were being used to restrain inflationary pressures, the possibility that banks would withdraw from membership was a factor inhibiting policy decisions. It is easy to imagine the recurrence of situations in which it would be appropriate to raise reserve requirements but willingness to adopt this measure might be affected by the threat of withdrawal of banks from the System. If all commercial banks were subject to the reserve requirements of the Federal Reserve, this type of inhibition on monetary policy would not arise.

Against these considerations, it has been argued that neither compulsory membership nor compulsory reserves are essential to the conduct of monetary policy, on the grounds that most medium-sized and larger banks would voluntarily retain membership and that Federal Reserve open market operations and discount policy would have their effect even in the absence of required reserves. But most members of the Committee believe that monetary policy would be strengthened if all commercial banks were required to maintain reserves in the amounts and form specified for member banks.

Equity and competitive advantage.—Reserve requirements imposed by the States, and therefore applicable to nonmember banks, tend to be less onerous than those applicable to member banks of the Federal Reserve System. In some States, the level of requirements is lower. More important, the form in which reserves may be held is more favorable to nonmember banks. In a number of States, reserves may be held partly in the form of securities, and therefore may earn interest. Furthermore, correspondent balances, which nonmembers would maintain in some amount even in the absence of reserve requirements and from which they derive benefits, serve to satisfy part or all of State reserve requirements. In States where reserve requirements are at the

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same level or even higher than those for member banks, the form of reserves is favorable to nonmembers.

These differences in reserve treatment tend to confer a competitive advantage on nonmember banks by permitting them to offer more attractive terms to borrowers and depositors or to earn higher profits than member banks in similar circumstances. But, under present conditions, the only escape from this inequity for member banks is withdrawal from the System, and this also means escape from the reserve base directly under the control of the Federal Reserve. National banks can escape from this inequity only by giving up their national charters.

Compulsory membership.—The principal advantages of universal membership by commercial banks in the Federal Reserve System would be achieved if all commercial banks were subject to the reserve requirements of the Federal Reserve and membership for State-chartered banks remained voluntary.

Once the principle of compulsory reserves is accepted, a major remaining deterrent to full membership is the requirement that member banks remit at par for checks drawn upon them. The fact that some nonmember banks, concentrated in a few areas, still maintain the practice of making a charge against the payee for remitting on checks against them is an impediment in the payments mechanism of the United States. In addition, the problem of sorting out checks on these institutions and charging back in an equitable way these so-called "exchange" charges to the persons who have accepted checks at face value for amounts owed to them is costly and time consuming. The Committee favors par clearance in principle. But it recognizes that elimination of the impediment in the payments system would materially affect the 1,600 banks (with 1,900 offices) that do not now remit at par.

If full membership remains compulsory for national banks while other commercial banks are required to adhere only to the reserve requirements of the Federal Reserve, another class of relationship between banks and the Federal Reserve will result. A majority of the Committee sees no reason to change the existing requirement that national banks be full members of the System. At the same time, to require that State-chartered banks become full members would provoke needless controversy; as noted, the major advantages of full membership would be achieved if all commercial banks were brought under the reserve base of the Federal Reserve.

Conclusion 1.—The Committee, with one member dissenting, concludes that all commercial banks ought to be subject to the reserve re-

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quirements specified by the Federal Reserve, and ought to have access to Federal Reserve discounts and advances. Membership in the Federal Reserve System would continue to be voluntary for State-chartered banks.

The Structure of Reserve Requirements on Demand Deposits

Member banks of the Federal Reserve System are required to hold reserves in the form of either deposits at Federal Reserve Banks or vault cash. The present reserve requirement against net demand deposits is 12 percent for banks classified as "country" banks and 16½ percent for "reserve city" banks. Under existing law, the Federal Reserve Board has discretion to set these reserve requirements between 7 and 14 percent for country banks and between 10 and 22 percent for reserve city banks.

The geographical classification between "city" and "country" banks, with differential reserve requirements, dates back to the National Bank Act (1863), under which "reserve city" banks served as reserve depositaries for country banks and in turn maintained reserves with "central reserve city" banks. Differential reserve requirements were viewed as necessary in that system as a means of protecting the liquidity of the banking system.

The ineffectiveness of required reserves as a means of ensuring bank liquidity was demonstrated forcefully by the prevalence of financial panics. Indeed it was these difficulties, resulting from the lack of a dependable source of liquidity, that led in 1913 to the establishment of the Federal Reserve System, which has come to be the ultimate provider of liquidity in our monetary system. Nevertheless the three-way geographical classification of banks was carried over from the National Banking System. It was only in 1959 that the three classifications were reduced to two by a consolidation of the two city-bank categories.

Other shortcomings of the existing structure of reserve requirements have become evident. In the past, large banks, which were located mainly in central cities, were concerned principally with serving the needs of industry and commerce and of out-of-town banks. In recent years, consumers have become increasingly important as depositors and borrowers at large city banks. Moreover sizable concentrations of population and business outside the limits of reserve cities, especially in the suburbs, have led to wider branching and substantial growth of many banks in these areas. The result has been that the distinction in size and function between "country" and "city" banks has become blurred. In these circumstances, banks of comparable size and similar activity are more likely than in the past to have different

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reserve requirements, depending on where they are located. Furthermore, the question whether or not a city should be classified as a reserve city, with the consequence that its banks would have a higher reserve requirement, is a difficult one and inevitably leads to arbitrary distinctions.

Recognition of these problems has stimulated numerous proposals in recent years for revision of the system of reserve requirements. One such proposal is for identical percentage requirements at all banks. The American Bankers Association is on record in favor of this proposal. Most recently, the Commission on Money and Credit recommended uniform reserve requirements.

The case for uniform requirements is usually based on two arguments: (1) that monetary policy would become a more precise instrument if all banks had the same requirements, since potential credit and monetary expansion would no longer vary with changes in the distribution of demand deposits among banks in different locations, and (2) that the present differential is arbitrary and imposes inequitable treatment on many banks.

The Committee recognizes the logic of the argument, presented by the Commission on Money and Credit and others, that completely uniform requirements would enhance the precision of monetary policy. At the same time, it is aware that, as a practical matter, the difference in reserve requirements between city and country member banks introduces only a minor imprecision into the management of bank reserves by the Federal Reserve. Greater imprecision results from the fact that small banks maintain sizable excess reserves and, in contrast to larger banks, adjust their loans and investments only with a lag when their reserves change. For this reason, required reserves would be affected when deposits shift between city and country banks even if reserve requirements were uniform.

A system of differential reserve requirements is defended on the grounds (1) that smaller banks find it necessary, in order to obtain certain services from their city correspondents, to hold a large proportion of their assets in the form of non-interest-bearing balances at other banks and (2) that smaller banks are necessarily higher cost banks, in view of their lesser ability to take advantage of economies of scale (such as avoiding excess reserves, making large individual loans and investments, and using automatic accounting equipment and other specialized facilities); a lower level of reserve requirements may serve to offset these disadvantages of smaller banks, thus helping to preserve a system of independent unit banks.

As it considered these arguments, the Committee was aware of the practical difficulty of implementing the two recommendations of the

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Commission on Money and Credit that all (insured) commercial banks should be required to become members of the Federal Reserve system *and* that reserve requirements should be identical for all member banks. Nonmember banks are predominantly small banks. Among the 7,000 banks that are not members of the Federal Reserve system, more than three-fourths have total deposits of less than $5 million. If these banks were required to adhere to member bank reserve requirements and if requirements were made uniform at anything like present levels (somewhere between 12 and 16½ percent), a strain would be imposed on many of the small nonmember banks. To implement the two recommendations therefore, it would probably be necessary to lower the present average level of reserve requirements on member banks, perhaps to less than 10 percent.

Although reserve requirements serve mainly as a vehicle for monetary policy, there is, within broad limits, little basis for judging that in the long run one level is preferable to another in terms of facilitating monetary policy. Inevitably therefore the other effects of reserve requirements—on bank earnings, on competitive relationships with other institutions, and on net interest payments by the Government—become relevant in evaluating the advisability of a change in the average level of requirements. It is clear that a substantial reduction in requirements—to 10 percent or less—would, at least in the short run, result in a sizable increase in net profits of banks (especially of larger banks in reserve cities now subject to a requirement of 16½ percent) and a corresponding reduction in net receipts by the U.S. Government, taking into account payments by the Federal Reserve to the Treasury.

The Committee has examined other means of altering the structure of reserve requirements, in a way that might represent an improvement over the present arrangement for member banks, and might also accommodate small nonmember banks if they were required to maintain reserves as specified by the Federal Reserve Board, while causing a minimum of transitional disturbance.

The Committee has analyzed in specific terms a possible graduated system of reserve requirements, and a large majority was convinced that, under present circumstances, an approach along these lines was the most practical. Under such a system, every bank would maintain a low reserve against the first few million of its net demand deposits. a higher reserve against its deposits above this minimum amount and up to a substantial figure, and a still higher reserve against net demand deposits, if any, above the latter amount. By way of illustration, banks, at least initially, might be required to keep a 7-percent reserve requirement against the first $5 million of net demand de-

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posits; a 12-percent requirement (the present country bank level) against the next $95 million, and a 16½-percent requirement (the present city bank level) against net demand deposits above $100 million. As at present, ranges within which the Federal Reserve could vary the required percentages would be specified for each bracket—ranges which probably should overlap, at least for the two higher brackets.

A system of this type would represent an improvement over the present system, whether or not all commercial banks were subject to the reserve requirements of the Federal Reserve. It would bring some of the advantages of uniform reserve requirements, since banks of the same size (with respect to demand deposits) would be subject to identical requirements regardless of location. The sharp differential between classes in the present two-way classification would be replaced by a smoothly graduated system. As a bank grew and passed into another reserve bracket, the higher requirement would apply only to its marginal demand deposits. The character of the present reserve requirement structure could be preserved to the extent deemed desirable, by continuing to place higher marginal requirements on larger banks. Similarly, a graduated system would facilitate a transition to greater uniformity—or, to full uniformity—if and when desired.

Conclusion 2.—The Committee, with one member dissenting, concludes that a system of graduated reserve requirements for demand deposits would eliminate many of the inequities and administrative difficulties in the present system of reserve requirements and would facilitate a decision to bring all commercial banks under the reserve jurisdiction of the Federal Reserve.

Reserves on Time Acccounts

The present reserve requirement against time (and savings) deposits at member banks of the Federal Reserve System is 4 percent and the range within which it can be varied under existing law is between 3 and 6 percent. From the time of establishment of the Federal Reserve System, the reserve requirement against time deposits has been identical at all banks, although the legal authority exists for differential ratios at different classes of banks.

Under the National Bank Act (1863), reserve requirements on time deposits were at the same level as on demand deposits. Provision for a lower requirement on time than on demand deposits in the original Federal Reserve Act (1913) reflected a belief that time deposits are less volatile and require less liquidity backing than demand deposits.

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As noted earlier, commercial bank reserve requirements are now regarded as providing only a minor degree of liquidity. Their major function is to facilitate central banking actions designed to affect bank credit and deposits.

Recommendation of Commission on Money and Credit.—The Commission recommended repeal of statutory reserve requirements on time and savings deposits. It stated that the principal justification for such requirements "is to impress upon financial management the need for making provision for liquidity" but "management and supervisory authorities are able to see to it that such liquidity as may be necessary with respect to such deposits is maintained."

The discussion in the Commission's *Report* stated further that if "it is deemed wise to continue statutory reserves against savings and share accounts," the requirement "should be designed to minimize any differential effect on the earning capacity of various institutions competing for savings." The Commission suggested that this could be accomplished by permitting "liquidity reserves to be held in cash or short-term Government securities."

Reserves on time accounts and monetary policy.—In view of the primary function of required reserves—to serve as a fulcrum for monetary policy—the question may properly be asked whether required reserves on time deposits and shares are a necessary part of the fulcrum. Could monetary policy be effectively conducted without reserve requirements on commercial bank time deposits? Are reserves on accounts at other savings depositaries needed as a means of strengthening monetary policy?

These are questions to which neither economic theory nor central banking experience gives clear answers. Those who regard the money supply, narrowly defined to include only currency and demand deposits, as the major variable through which monetary action influences economic activity are likely to believe that reserve requirements on time and savings deposits are unnecessary, either at commercial banks or at other institutions.

Those who prefer a definition of the money supply that includes time deposits at commercial banks (as well as those who regard commercial bank loans and investments as the major variable) view reserve requirements on time deposits as an important adjunct of monetary policy. In fact this view has led some observers to the proposition that there should be little if any differential between requirements on time and on demand deposits.

Another widely accepted view stresses the belief that time deposits at commercial banks and savings accounts at other financial institutions are close although imperfect substitutes for demand deposits.

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Shifts between demand deposits and savings accounts are said to be responsive to changes in interest rates and are reflected in the rate of turnover (or velocity) of demand deposits. In periods of monetary restraint, for example, rising interest rates are said to attract funds from demand deposits to time, savings, and share accounts. Because of the difference in reserve requirements (and their absence at some institutions) this permits an expansion of credit at the institutions whose deposits or shares increase, without a corresponding contraction in demand deposits and credit at commercial banks, unless the Federal Reserve takes action to absorb reserves. Some have concluded, on this basis, that monetary policy is blunted by the existence of a difference in reserve requirements as between money proper and money-substitutes such as deposits and shares in savings institutions, and would be further weakened if there were zero reserve requirements against time deposits at commercial banks. They call for a measure of control by the central bank over the reserves of all institutions whose liabilities are close substitutes for money.

These differences in approach and their implications for policy have been widely discussed and analyzed in recent years, not only in the economic literature and the financial press in the United States but also in many other countries; a notable example is the Radcliffe Report (1959) in the United Kingdom, which in general adopted the third approach noted above.

The Committee does not pretend to have resolved the issues raised in this wide-ranging and many-faceted discussion. It observes, however, that the empirical evidence for the United States does not offer strong support for the proposition that, in practice, the operations of nonbank financial intermediaries have offset or seriously weakened countercyclical monetary policy. On the contrary, experience to date has shown that the nonbank institutions tend to grow faster when monetary policy is encouraging expansion of commercial bank assets and liabilities and to grow less rapidly in periods of monetary restraint. Time deposits at commercial banks have tended to behave in a similar manner, although interpretation of this experience is clouded by the two postwar increases (in 1957 and 1962) in maximum permissible rates payable on commercial bank time and savings deposits.

The evidence also shows that since the end of World War II, the nonbank savings institutions have grown faster than commercial banks. This in turn may help to account for the upward trend in monetary velocity experienced over this period. Yet, many other influences were at work, including the substitution of short-term securities for demand deposits, as market interest rates rose from the low levels of the early postwar period.

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At the present time therefore, the Committee believes that it is difficult, on grounds of essentiality to effective monetary policy, to support either maintaining the existing requirement on time deposits or extending direct central bank controls to nonbank financial institutions. In fact, the Committee noted that extension of reserve requirements to nonbank institutions—with the reserves taking the form of deposits with the Federal Reserve—might at times complicate rather than simplify the task of monetary management. For example, under present circumstances, a decision by the public to transfer funds out of securities and into nonbank savings institutions has no effect on member bank required reserves (and little, if any, effect on the economy). If, however, all savings institutions were required to maintain reserves at the Federal Reserve, a switch from securities to savings accounts, or *vice versa*, would increase or decrease required reserves. If these restraining or stimulating effects were to be avoided, offsetting Federal Reserve operations would be necessary.

Nevertheless, the Committee recognizes that reserve requirements on nonbank institutions, even if not kept at the Federal Reserve, could at times serve as a supplement to the existing instruments of monetary policy. Furthermore, there are reasons other than the need for quantitative credit and monetary controls that justify applying cash reserve requirements to nonbank depositary institutions.

Liquidity, equity, and supervisory considerations.—The Committee is aware that some savings institutions need to make additional provision for liquidity. The liabilities of savings and loan associations, mutual savings banks, and credit unions are widely regarded by the general public as being withdrawable on demand. Whatever the legal considerations applicable to such savings accounts, institutions must in practice be prepared to meet demands for withdrawals promptly. Yet the assets of these institutions are concentrated in instruments, primarily mortgages, which are inherently illiquid.

It is true that monthly repayments provide a steady cash inflow which contributes significantly to day-to-day liquidity needs. It is also true that the ultimate liquidity of the economy can be provided only by an effective central bank. Yet, within this framework, individual institutions, and all other economic units, should manage their portfolios so that, in ordinary circumstances, they can meet their own liquidity needs.

It has traditionally been a function of supervisory agencies to ensure that financial institutions maintain an adequate degree of liquidity and remain solvent. The Committee takes the view that it is necessary and desirable to strengthen the authority of the existing supervisory agencies, in particular the Federal Home Loan Bank

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Board in its relationship to member savings and loan associations. This relationship involves surveillance and influence over the practices of savings institutions, including the extent to which institutions make provision for liquidity in order to be in a position to meet withdrawals. The Committee believes that if the associations were required to maintain a cash reserve at the Federal home loan banks the relationship between the supervisory agency and the supervised institutions would be strengthened in the public interest. The influence of the supervisors would be enhanced by the existence of the cash requirement and the power to change it. The institutions in turn would become more acutely conscious of the role of the Federal Home Loan Bank System as a governmental institution operating in the public interest.

Two additional considerations support the proposal for cash reserve requirements at all savings depositary institutions. First, it would eliminate the existing inequity wherein commercial banks must maintain cash reserves against time deposits but competing savings institutions have no such requirement. The alternative way to remove this inequity—namely, eliminating the requirement at commercial banks—would have the disadvantage of increasing the incentive of banks to induce depositors to hold in the form of time deposits what are in fact demand deposits. Second, such a cash requirement, even if it were not kept at the Federal Reserve as an instrument of monetary policy, could be used at times as a supplement to monetary policy. Increases in the reserve requirement would serve to limit the lending power of savings institutions and reductions would increase their lending power.

The Committee has noted the relationship of a proposal for a cash reserve requirement on savings institutions both to the policy of the Federal Home Loan Bank System with regard to advances to member institutions and to the earnings of the home loan banks. It is expected that the System's advances policy would not become any more liberal because of the cash reserve requirement.

The substantial amount of funds that would accrue to Federal home loan banks when the proposed cash reserve requirement became effective should in ordinary circumstances be reinvested in U.S. Government securities. Only at times of substantial and widespread withdrawals of funds from member institutions should the Federal Home Loan Bank System be expected to use for advances the funds accruing to it as a result of the cash reserve requirement. In addition, as in the case of Federal Reserve banks, dividends to member associations should be limited to 6 percent, and net earnings of Federal home loan

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banks, after additions to reserves and payment of dividends, should be paid over to the Treasury.

A similar cash reserve requirement is desirable in the case of mutual savings banks. Which Federal agency would hold the required reserve balances will presumably depend on what action if any is taken on the question of Federal charters for mutual savings banks.

The Committee also considered whether such a requirement is necessary and desirable for credit unions. No such recommendation is made at this time. The reasons for this conclusion are discussed more fully in chapter VI in connection with the subject of Federal insurance of credit union shares.

Conclusion 3.—The Committee, with one member dissenting, favors the continuation of reserve requirements on time and savings deposits at commercial banks and the introduction of a similar reserve requirement for shares at savings and loan associations and deposits at mutual savings banks. In addition, Federal agencies that supervise financial institutions should be endowed with sufficient authority to assure that the institutions maintain adequate liquidity over and above cash reserve requirements.

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Chapter III

INTEREST RATE REGULATION

The Federal Government regulates rates of interest paid on deposits at commercial banks. In particular, payment of interest on demand deposits is prohibited and rates paid on time and savings deposits are subject to ceilings determined by the Federal Reserve Board and the Federal Deposit Insurance Corporation.

These controls were introduced into Federal legislation by the Banking Acts of 1933 and 1935. Prior to that time there had been no direct Federal control over interest paid on deposits.

The major reason for enactment of the prohibition of interest on demand deposits in 1933 was apparently to prevent a recurrence of certain developments that were thought to have contributed to the financial debacle of 1929–33. The stock market boom of the late 1920's had involved financing through the call loan market at high rates of interest. This market was fed in part by New York and other large city banks, which invested deposit balances of interior banks that were drawn to the large city banks by the payment of attractive interest rates. The major purpose of the prohibition was to limit the drawing of funds from interior banks to money centers for speculative purposes.

The authority to regulate maximum rates paid on time and savings deposits had a somewhat different purpose. It was designed to limit interest rate competition among banks, on the grounds that such competition had tended to drive up interest rates on time and savings deposits and thereby induced banks to acquire high-yielding but unsound assets. There was a widespread feeling that such motivations had contributed to many bank failures, even before the depression. In the years 1921–29, more than 5,000 commercial banks were forced to close their doors because of financial difficulties. Concern over the soundness of bank assets may also have been a factor in the decision to prohibit interest on demand deposits.

Major questions.—The Committee weighed the question whether the prohibition of interest on demand deposits remains justified under present-day conditions. With respect to regulation of maximum rates on time and savings deposits, the Committee considered the alternatives of (1) maintaining the *status quo*, (2) converting the control

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to a standby basis, (3) and eliminating the control; related to these alternatives is the question of extending regulation, if any, to other financial institutions that accept time and savings accounts.

Recommendations of Commission on Money and Credit.—The Commission recommended that the prohibition of interest on demand deposits be continued. In the case of time and savings deposits, it recommended that the present authority be converted to a standby basis and be extended, under the appropriate Federal agencies, to mutual savings banks and savings and loan associations.

The Commission noted that commercial banks must compete for time and savings deposits with other financial institutions whose rates are presently unregulated, and its recommendation for suspension of the regulation of maximum rates on time and savings deposits was apparently based in good part on a wish to eliminate this competitive disadvantage under which commercial banks are forced to operate.

Interest on Demand Deposits

Some of the important considerations that apparently motivated enactment of the prohibition in 1933 have little force today. The call loan market is of minor importance. Stock market credit is regulated by Federal Reserve margin requirements. Consequently, there is little likelihood of a repetition of the experience of the 1920's when stock market speculation attracted funds, including interbank deposits, from the interior of the country to New York.

Payment of interest on demand deposits could, however, give rise to related problems. If the prohibition were eliminated, it has been argued, banks in financial centers would compete more actively for demand deposits of businesses and institutions and would succeed in attracting deposits away from banks in smaller communities. This in turn might have undesirable effects on the availability of bank credit in smaller communities. Competitive bidding for demand deposits might also induce banks to reach out for unsound assets in order to increase earnings. These considerations are regarded by some members of the Committee as the present-day counterpart of the dangers that promoted acceptance of the prohibition in 1933.

Another consideration favoring the prohibition of interest on demand deposits is that it helps to preserve the fundamental distinction between the payments medium and liquid savings—a distinction that underlies the existing arrangements for monetary control.

Those who favor elimination of the prohibition argue that the holding of demand deposits is made unnecessarily costly to the depositor. The cost is measured by the interest foregone when demand deposits are held instead of interest-earning liquid assets. In order to minimize

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this cost, the public has an incentive to undertake frequent financial transactions designed to avoid loss of interest on what would otherwise be idle demand deposits—transactions that serve no economic purpose. The extent to which such transactions would be reduced in volume, if interest on demand deposits were permitted, was questioned by others, who also suggested that the costs involved are of minor significance.

A second consideration in favor of restoring interest payment on demand deposits is that it would tend to reduce cyclical fluctuations in monetary velocity and would therefore ease the task of the monetary authorities. It is argued that as interest rates vary over the business cycle, while the interest rate on demand deposits remains fixed at zero, there is a corresponding cycle in the incentive presented to the public to substitute interest-earning assets for demand deposits; this incentive is said to grow stronger in periods of high interest rates and weaker in periods of low interest rates and is reflected in a cyclical variation in the velocity of money. If interest payment were permitted, the rate paid on demand deposits would presumably move cyclically with other interest rates and the incentive to hold demand deposits would vary less over the business cycle, thereby dampening the extent to which movements in velocity tend to offset countercyclical monetary policy.

The practical significance of this point was questioned by a majority of the Committee on the grounds that even if interest on demand deposits were permitted, the rate is likely to remain low and inflexible. The rate on demand deposits would probably not be highly responsive to short-run market forces. As a result, the incentive to economize demand deposits would continue to vary directly with the cyclical movement in interest yields on short-term securities.

It is recognized both by those who favor and those who oppose a change in the present law that various practices exist by which interest is paid implicitly on demand deposits. In order to attract and keep demand deposits while adhering to the prohibition on explicit interest payment, banks may compensate some customers with more liberal loan terms and the provision of various free services; furthermore, service charges may be graduated or waived entirely.

Many Committee members believe that the banks and the public have by now adjusted to the substitution of implicit for explicit payment of interest on demand deposits; a reversion to explicit interest payment would therefore have very little beneficial effect and might be harmful for the reasons previously cited. Some feel, however, that if implicit interest were replaced by explicit interest, together with a requirement that interest rate schedules be published, treatment of depositors would be more uniform and equitable.

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In balancing these considerations, some members of the Committee favor repeal of the prohibition of interest payments on demand deposits and its replacement with standby authority to prohibit interest or establish a maximum rate if the possible dangers cited by the majority turned out to be realized. In addition to the considerations outlined earlier, this view is based on the thought that demand deposits and other types of deposits and shares are sufficiently similar and substitutable to merit similar regulatory treatment. A majority of the Committee believes that this differential treatment is justified, on the grounds that demand deposits constitute the fundamental medium of exchange in our economy and as such should be subject to unique restrictions, which are not necessary in the case of financial assets serving only as a store of value but not as a medium of exchange.

Conclusion 4.—The Committee, with three members dissenting, concludes that the prohibition of interest payments on demand deposits should be continued.

Interest on Time and Savings Accounts

The Federal Reserve Board and the Federal Deposit Insurance Corporation are presently required by law to establish maximum rates on time and savings deposits.[1] Between 1936 and 1957, the regulations specified a maximum rate of 2½ percent. This was raised to 3 percent as of January 1, 1957, and to 4 percent as of January 1, 1962. At the present time, the maximum rates are as follows:

	Percent
Savings deposits held for:	
1 year or more	4
Less than 1 year	3½
Time deposits payable in:	
1 year or more	4
6 months to 1 year	3½
90 days to 6 months	2½
Less than 90 days	1

The case for ending Federal regulation of interest rates on time and savings deposits rests mainly on the presumption that, in the absence of strong evidence to the contrary in particular cases, the public interest will best be served if the forces of supply and demand are permitted to reflect themselves in prices, including interest rates. In particular, the presumption is that both equity as between buyers and sellers (or lenders and borrowers) and the allocation of resources will be more satisfactory when prices and interest rates are free to reflect market forces.

[1] An Act of Congress approved on Oct. 15, 1962, provided that, for a period of 3 years, deposits of foreign governments and certain foreign official institutions were exempt from interest ceilings.

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An analogy with governmental regulation of prices charged by public utilities is sometimes suggested. In view of the fact that public utilities are inherently in a monopolistic position, price regulation is designed to prevent monopolistic pricing while other regulations are designed to assure adequate service to the public. Although Government regulation limits competition in the field of banking—in part by restrictions on the establishment of new banks—existing interest rate regulation is not at all comparable to price regulation in the public utilities field. If deposit interest rate regulation were analogous to price regulation over public utilities—that is, if it were designed to protect the public from monopolistic pricing—the regulation would impose a floor, not a ceiling, on interest rates.

When originally enacted, the objective of this regulation was to help assure sound banking. The Committee takes the view that improvements in bank supervision and examination in recent decades make continuous regulation of interest rates unnecessary as a means of preventing acquisition of unsound assets. In addition, the pervasive use of amortized and of Government-backed mortgages today, in contrast with the 1920's, lessens the danger of serious losses by banks in the investment of time deposits.

Another consideration is that the present regulation applies only to commercial banks and not to other institutions with which they compete for funds. This difference in regulatory treatment results in a competitive disadvantage for commercial banks.

Consideration was also given to the possibility that under certain conditions competitive bidding up of rates paid on time and savings accounts might produce undesirable repercussions, particularly in the mortgage market.

On balance, the Committee believes that the case for continuous regulation has less force today than in 1933. Nevertheless, recognizing the possibility of a recurrence of the need for maximum rates, the Committee does not propose that interest rate regulation be completely abandoned. Rather, it should be placed on a standby basis and extended to other depositary-type institutions. The very existence of such standby authority would help to prevent excessive increases in rates paid.

The Committee envisages that such standby authority would be invoked by the responsible supervisory agencies only when they deem it necessary either to prevent institutional practices in the payment of interest and extension of credit that were inconsistent with the safety and liquidity of a significant number of institutions or to supplement other governmental policies to promote the objectives of the Employment Act of 1946.

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In either case, the Committee believes that the supervisory agencies should be given wide discretion in invoking the standby authority. This discretion should include the authority to impose different rates on different kinds of deposits, classified by type of holder, maturity, location, or other characteristics, and to apply a maximum rate only to some types of deposits. The Committee believes, for example, that the reconciliation of domestic aims with balance of payments considerations might at times justify different ceilings on domestic and foreign deposits, or perhaps limitations on rates of one of these groups but not the other. Rate ceilings on some or all domestic accounts might under unusual circumstances be useful in exerting a marginal influence on the flow of funds and terms available for certain types of credit, such as mortgages, although the Committee does not feel that interest rate regulations should ordinarily be used as a means of affecting the allocation of credit.

In these circumstances coordination among the supervisory agencies would be especially important. This matter is discussed in Chapter IX.

The Committee is aware of an administrative difficulty that would arise if ceiling rates on time deposits were eliminated while the prohibition on demand deposits were retained. One of the problems faced by the Federal Reserve and the FDIC even under the present legislation is to prevent demand deposits from earning interest in the guise of short-maturity time deposits. This problem has been met in the past by establishing a relatively low maximum rate on short-term time deposits. If continuous regulation were eliminated, policing the prohibition of interest payment on demand deposits would become more difficult. The broad authority suggested above would make it easier to deal with this problem.

Conclusion 5.—The Committee believes that the purpose served by continuous regulation of interest rates on time and savings deposits would be served equally well by standby authority to impose maximum rates, and that this regulation should apply as well to nonbank financial institutions that accept deposits or shares. The standby authority might be invoked either to help assure the continued safety of the institutions or to promote the stability of the economy. In exercising this authority, the supervisory agencies should be permitted to establish, at their discretion, different maximum rates for different accounts according to type, holder, maturity, or other characteristics.[3]

[3] One member of the Committee dissents from the last sentence of this conclusion.

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Chapter IV

PORTFOLIO REGULATION

Financial institutions are subject to restrictions, both qualitative and quantitative, on the assets they may acquire. The Federal Government imposes restrictions on the lending and investing activities of federally chartered institutions (national banks, Federal savings and loan associations, and Federal credit unions) while portfolio restrictions on State-chartered institutions are, for the most part, a matter of State laws. There are, however, some exceptions to this generalization—that is, cases in which Federal statutes limit the lending and investing activity of State-chartered institutions; these exceptions apply mainly to State-chartered member banks of the Federal Reserve System. There are virtually no specific portfolio limitations imposed on State-chartered institutions by the Federal Government in its capacity as insuring authority, but Federal insurance agencies have responsibility for examination of the quality of assets and the adequacy of capital at State-chartered institutions.

Portfolio restrictions are to a large extent the historical product of periodic waves of failures of banks and other institutions with consequent losses to depositors (or other claimants) and disruption to the economic life of the communities involved. Much of the restrictive legislation has been added in a piecemeal manner, in response to specific problems. Similarly, exceptions and exemptions, both general and specific, to these restrictions, have been enacted at various times, in response either to pressures from regulated institutions for less burdensome restrictions or to a desire by government to encourage or discourage particular lending activities.

The trend in recent decades has been toward less stringent restrictions. For example, since 1927 national banks have been permitted to acquire mortgages of progressively longer maturity than the 1-year maximum of that time. Similarly the authority for Federal savings and loan associations to acquire assets other than mortgages on single-family dwelling units has been repeatedly broadened.

At the same time, the attitudes and practices of financial institutions have changed. The traditional view of commercial banks as short-term lenders to business has been modified as banks have placed a significant proportion of their assets in longer term instruments (such

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as term loans and mortgages) and have attempted to meet both the short- and long-term financing needs of consumers (in the form of consumer instalment credit and residential mortgage credit).

Purposes of portfolio regulation.—Restraints on the lending and investing activity of financial institutions have two broad purposes: to safeguard their solvency and liquidity and to maintain a degree of specialization in their functions.

Portfolio restrictions, along with other governmental policies, such as limitations on the establishment of new financial institutions, are designed to insure the solvency and liquidity of financial institutions responsible for maintaining the money supply and for handling the liquid savings of individuals and businesses. The Nation as a whole has an overriding interest in assuring universal acceptability of the means of payment and in preventing the disruption to individual communities and to the economy generally of failures of financial institutions. While these purposes are now served in part by deposit and share insurance, the Federal Government has a direct interest in preventing insolvency in its incipient stages.

Portfolio regulation is also related to the specialized nature of financial institutions. Specialization is most marked in the case of credit unions and savings and loan associations. It is less evident in mutual savings banks and still less in commercial banks. To some extent, the enforcement of specialization by means of portfolio restrictions can be traced to a desire to confine institutions to types of lending activity most appropriate either to their management structure or to the nature of their liabilities. Portfolio regulation is also designed to promote national policies, notably encouragement of home ownership, through specialized institutions.

Major issues.—The Committee considered the following questions concerning portfolio regulation: (1) To what extent, if any, should regulation continue to impose a degree of specialization among financial institutions? (2) In what ways consistent with other objectives might regulatory policy better promote competition between institutions, mobility of funds (geographically or among sectors of the economy), or risk taking? (3) Does the multiplicity of regulations and supervisory authorities introduce serious inequities or inconsistencies in the availability of loans and investments?

Recommendations of Commission on Money and Credit.—The Commission recommended "that the regulatory authorities be authorized to permit greater flexibility to savings banks and savings and loan associations to acquire a wider range of suitable long-term debt instruments. Commercial banks should be allowed the same flexibility in investing their time and savings deposits. Financial institutions

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should be permitted to change their investment practices but they would not be obliged to do so." It recommended further that investment in equities continue to be restricted, but called for equal treatment, at the least burdensome level of mutual savings banks, savings and loan associations, and commercial banks in the investment of time and savings deposits. The Commission also recommended a liberalization of restrictions on the geographical area over which institutions may lend.

The background discussion of these and related recommendations in the *Report* of the Commission states that they were designed to encourage the safety of the financial system, on the one hand, and to provide greater flexibility for portfolio investment, increased mobility of funds, and increased alternatives for savers and borrowers as a means to stimulate economic growth, on the other. These recommendations would, according to the *Report*, "enable the financial institutions to become less specialized in investment, if they so desired. The recommendations are not intended to alter the specialized powers of the institutions to offer the forms of financial assets and the services which they now provide."

Considerations Regarding Specialization

The Committee recognizes the disadvantages of excessive specialization among financial institutions. By inhibiting adequate diversification of loans among industries and sectors of the economy, specialization could make financial institutions more vulnerable to insolvency arising from adversity in the particular industries or sectors in which their lending is perforce concentrated. A related danger is that a restricted choice of lending power may induce institutions to reach out for unduly risky loans of the permitted type in an effort to invest funds fully when credit demands in the specialized area are declining.

If specialization is overdone, the resulting restrictions on the mobility of funds may have harmful effects on resource allocation. Unless loan funds of institutions can shift with reasonable facility from one use or one locality to another in response to changing needs, important market distortions are likely to persist, with adverse consequences for growth and efficiency. If savings institutions are overly specialized, such shifts are likely to be slow and cumbersome, since they must await shifts of funds by depositors or savers from one institution to another. Excessive specialization may also restrict competition among lenders, to the detriment of borrowers, especially those outside of urban centers who may have access to relatively few institutions of each type.

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On the other hand, a degree of specialization can contribute to both solvency and efficiency in a setting characterized by many small institutions. Management is induced to concentrate in relatively limited sectors of the credit market, and the ability to appraise basic values and risk may be enhanced. Concentration on certain sectors, when the supply of managerial talent and size of institutions is limited, can also help promote more efficient techniques and economies of scale.

Moreover, specialization in the lending activities of at least some types of institutions provides to Government a vehicle for stimulating or, if need be, restraining lending activity in particular sectors in accordance with broad social objectives. This can be done through central reserve institutions or special treatment in other respects. Even more broadly, specialization provides some assurance that certain types of borrowers with needs deemed important from the standpoint of the public interest and the efficient performance of the economy can be assured access to a set of institutions particularly attuned to, and sympathetic with, their special problems and requirements. In addition, specialization serves to prevent large and sudden shifts of funds from one sector of the economy to another in response to short-run deviations in rates of return—shifts which could, when real resources cannot be shifted with equal speed, seriously affect particular industries and complicate the task of achieving economic stability.

In balancing these considerations, the Committee is inclined toward the view that there is merit in continuing to charter institutions somewhat specialized in their lending activities. But this approach would not preclude some broadening in the lending powers of specialized institutions. In general, the greater assurance which national policies and institutions now provide against severe economic and financial collapse should permit some redirection of portfolio regulation, consistent with the objectives of solvency and liquidity, toward greater mobility of funds, freer competition, and further flexibility for innovation.

Portfolio Policy for Commercial Banks

By tradition, commercial banks tend to give priority to the short- and intermediate-term borrowing needs of business. Through their handling of demand deposits, commercial banks are already closely attuned to the needs and circumstances of their local business communities. This orientation helps to assure a flow of credit to smaller and more localized businesses which lack ready access to the broader money and capital markets. The Committee believes that this basic orientation has much to commend it.

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Commercial banks have, however, developed diversified lending activities beyond business loans, and it is appropriate that they continue to do so. Commercial banks are the most widely dispersed geographically of all lending institutions; they attract funds of individuals as well as businesses; they are necessarily in close contact with all elements in a community; and they are sometimes the only institution conveniently available to local borrowers. Moreover, diversification in the lending activities of commercial banks helps to assure that specialization among other types of institutions will not endanger either the mobility of credit between sectors or effective competition.

Because of the primary orientation of banks toward business lending, and because of the volatility of some of their liabilities, retention of some aggregate limitation on the size of their home mortgage portfolios appears consistent with a desirable degree of diversification. The existing limitation for national banks was recently raised by Congress from 60 to 70 percent of their volume of time and savings deposits.

Limitations on the volume of funds advanced to one borower are felt to remain an appropriate means of enforcing diversification. However, the current limit of 10 percent of capital and surplus applied to national banks might usefully be reviewed to determine whether, consistent with adequate diversification, some liberalization is desirable to permit banks more effectively to serve the needs of their larger customers, and whether the existing network of exceptions to the loan limit is beneficial.

The Committee believes that some detailed portfolio restrictions might better be determined by supervisory authorities on the basis of general statutory guidelines. This would facilitate timely adjustments to basic changes in lending conditions and economic circumstances. Discretionary authority of this nature exists in the case of regulations on the investment powers of commercial banks, with generally satisfactory results.

Portfolio Policy for Savings and Loan Associations

If Congress feels that the desirability of encouraging housing continues to justify special attention to the availability of residential mortgage credit, savings and loan associations might appropriately continue to concentrate their major efforts in that field. This will help to assure the continuation of widely dispersed facilities for mortgage loans to individuals through savings associations that have developed expertise and special interest in providing mortgage credit and handling individual savings.

While favoring the concept of some specialization of lending activity between groups of institutions, the Committee has been mindful, as

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noted, of the problems that might arise when such specialization is carried to the point that competition between institutions is stifled, and institutions are unable to shift any significant proportion of their funds to other sectors of the economy in response to changes in underlying economic conditions. Thus, authority for savings and loan associations to acquire mortgages on other than single-family residences, rather than being treated as exceptions to a general rule as at present, might be made more positive; and existing geographical limitations on lending might reasonably be liberalized. A majority of the Committee believes that consideration should also be given to providing statutory authority for savings and loan associations to engage in shorter term lending directly related to improving the "livability" of real estate through the purchase of major household durable goods; on the other hand, several members feel that further expansion into the field of consumer credit would be too much of a departure from the specialized function of mortgage lending.

Federal savings and loan associations must now confine their earning assets, apart from loans based on real estate or savings passbooks, to U.S. Government securities. It would be consistent with the regulatory principles here recommended to permit them to invest in high-quality State and local government bonds.

In recommending only a relatively modest deviation from the present portfolio regulations of savings and loan associations, the Committee has been influenced by its endorsement of a system of federally chartered mutual savings banks. The existence of such a system would provide an alternative for savings and loan associations that desired to engage in more diversified lending and investing, under appropriate supervision and safeguards.

Portfolio Policy for Mutual Savings Banks

Mutual savings banks, while generally confined to handling the savings funds of individuals and nonprofit institutions, typically have broader lending and investing authority, under State laws, than savings and loan associations. The Committee sees no serious problems in this area; it feels that this broader authority, such as is now permitted under State laws, is helpful in increasing the mobility of funds and should be retained if Federal charters are provided.

Portfolio Policy for Credit Unions

Credit unions might reasonably be expected to continue to concentrate on short- and intermediate-term consumer loans to their members. In the case of these institutions, considerations of safety and solvency loom particularly important, since credit unions are

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typically managed on a part-time basis by nonprofessionals whose judgment is likely to be most reliable in assessing the credit worthiness of their peers for relatively small consumer loans. Limitation to this kind of lending is also consistent with the special purpose of credit unions—which is, through cooperative action, to help close a possible gap in the availability of small loans to individuals.

The Extensicn of Federal Portfolio Regulations

Banking and thrift institutions are subject to portfolio regulations imposed by a multiplicity of authorities, State and Federal. Inevitably, this multiple system of supervision has led in some instances to unequal treatment of institutions in similar circumstances. In the Committee's view, these inconsistencies are not today a serious and immediate threat to the overall health of the financial system, nor do they appear to involve inequities so severe as to create a need at this time for a major overhaul of the regulatory structure.

The Committee does not believe that it is essential, in protecting the legitimate public interest, to extend Federal authority in the area of portfolio regulation to all banking and thrift institutions (or to all insured institutions). It recognizes that some differences in treatment will remain, although in specific instances these differences might legitimately stimulate review by both Federal and State authorities of the validity of their requirements.

There is one area, however, where the ability of Federal authorities to protect their interests should be strengthened. Supervisory and insuring authorities should have adequate powers to assure that all member institutions maintain at all times ample capital in accordance with guidelines established by those agencies. Sanctions short of the complete withdrawal of insurance or expulsion from membership should be available to these Federal authorities.

Conclusion 6.—The Committee recognizes that there are anomalies in the existing system of portfolio regulation, which are the product of a dual chartering system and of historical evolution. Nevertheless, the Committee sees no need for a drastic overhaul of existing portfolio regulations, nor for extending Federal regulations to State-chartered institutions.

Conclusion 7.—Some modification of the existing system is desirable. One aspect is broadening portfolio alternatives while not abandoning the concept of some specialization of financial institutions. In addition, many of the detailed regulations now spelled out in the statutes might well be left to the discretion of supervisory authorities, within statutory guidelines.

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Conclusion 8.—Federal supervisory and insuring authorities should have adequate powers to assure that all institutions subject to their respective jurisdictions maintain at all times ample capital in accordance with guidelines established by those agencies. These powers should be such that the authorities may enforce adequate provision of capital without the need to resort to expulsion from membership or termination of insurance.[1]

[1] The Comptroller of the Currency feels that he now has sufficient power to regulate the capital of national banks.

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Chapter V

FEDERAL CHARTERS FOR FINANCIAL INSTITUTIONS

Under existing law, both the Federal and State governments provide charters to commercial banks, savings and loan associations, and credit unions. For these three groups of financial institutions, there is a dual system of chartering and supervision.

In recent years, it has been proposed that Federal charters be available also to mutual savings banks. The Commission on Money and Credit supported this proposal and also recommended that Federal charters be available to life insurance companies.

Federal Charters for Mutual Savings Banks

In broad economic function, mutual savings banks resemble savings and loan associations. There are differences between the two types of institutions in their history, traditions, form of organization, legal nature of liabilities, and investment powers and practices. However, both perform the basic economic function of providing a relatively liquid earning-asset to individual savers and investing in long-term relatively illiquid obligations, mainly residential mortgages. As financial intermediaries, these institutions are more than mere middlemen between savers and borrowers. They hold assets which savers would for the most part be unwilling to hold directly, and their liabilities have a degree of liquidity which individual borrowers would be unable to provide directly.

In attracting funds, mutual savings banks and savings and loan associations compete not only with each other but with commercial banks as savings institutions. But mutual savings banks are concentrated in the northeastern part of the country, whereas savings and loan associations and commercial banks are found in the 50 States. Charters for mutual savings banks are available in only 18 States. Reflecting their historical origins, three-fourths of the savings banks are in three States—New York, Massachusetts, and Connecticut.

The proposal for Federal charters envisages that Federal mutual savings banks might come into existence in three ways: (1) by conversion of existing State-chartered savings banks to the form of Federal mutual savings banks, (2) by conversion of existing savings

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and loan associations (Federal or State-chartered), and (3) by the establishment of new institutions.

Analysis of the proposal.—Federal charters for mutual savings banks are supported in part on the ground that such charters are now available for competing institutions, and equity calls for similar treatment for savings banks.

It is further argued that if savings banks could spread to other parts of the country, the result would be (1) an increase in saving, (2) a better geographical distribution of saving in relation to investment needs, particularly for home-finance, and (3) more flexible and more competitive financial institutions.[1]

Proponents of Federal chartering have argued that personal saving tends to be higher in communities where mutual savings banks exist than in comparable communities without them. They further argue that Federal charters would contribute to an improved geographical distribution of saving by stimulating greater saving in those areas of the country—especially the West and South—where economic growth has been most rapid but where investment has been financed by savings attracted from capital surplus areas in the northeast.

Whether the evidence on the volume of savings deposits in communities with savings banks can be taken to imply that national or regional saving would increase in relation to national income if savings banks were more widespread is questionable. The spread of such institutions might merely result in a rechanneling of the flow of savings.

The Committee is generally disposed favorably toward measures that would enhance the mobility of savings in response to investment needs, where consistent with other important objectives. Whether the establishment of new Federal mutual savings banks or the conversion of existing institutions to that form would make a major contribution to such mobility is unclear, but it would presumably tend in that direction. To the extent that the availability of Federal charters led to increased competition for savings, the public would benefit from more favorable returns on amounts saved. Moreover, although an excessive multiplication of savings institutions could threaten the solvency of existing and new institutions, this danger seems remote in view of the chartering standards that now exist for other types of institutions and the standards that would presumably be applied in chartering new Federal mutual savings banks.

Mutual savings banks have wider investment powers than savings and loan associations and are in a better position to respond to changes

[1] National Association of Mutual Savings Banks, *Mutual Savings Banks* (a monograph prepared for the Commission on Money and Credit), 1962, pp. 261–266.

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in the composition of investment needs. It is argued that the opportunity to establish additional mutual savings banks, either by the chartering of new, or the conversion of existing, institutions, would provide a desirable safeguard against excessive specialization in mortgage financing by savings institutions. With appropriate statutory standards, a desirable strengthening in the liquidity position of many thrift institutions might also result. Furthermore, savings institutions would be better able to adapt, and less vulnerable, to a relative decline in the demand for residential mortgage funds, for with broader investment powers they could supply funds for other productive uses.

Bills under consideration would best the chartering and supervisory authority for Federal mutual savings banks in the Federal Home Loan Bank Board. This matter is discussed in chapter IX. The Committee's endorsement of Federal charters for mutual savings banks does not imply endorsement of any particular bill in the Congress.[2]

Conclusion 9.—The Committee concludes that voluntary Federal charters should be available for mutual savings banks, subject to adequate supervisory standards and safeguards.

Federal Charters for Life Insurance Companies

Life insurance companies are presently chartered in each of the 50 States. Companies that operate across State lines are subject to the regulations of the States in which they sell insurance as well as their home States. In practice, New York has been a key regulatory State by virtue of the fact that companies accounting for three-fourths of all life insurance are licensed to sell insurance in New York.

The Commission on Money and Credit recommended that "overriding Federal charters be available to life insurance companies," in order "to avoid increasing complications of multiple State jurisdictions * * *"

The Committee has had neither the time nor the resources to undertake an intensive study of the life insurance industry and its regulation. In part because the Federal Government has no supervisory responsibilities over insurance companies, existing knowledge and experience in the Government provide less foundation for judgment on this question than on most of the other issues within the Commit-

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[2] The Committee, while aware of the implications of differing Federal tax treatment of financial institutions (including mutual savings banks) for their growth and relative competitive positions, did not consider this range of problems as directly within its terms of reference. The Administration position on taxation of mutual savings banks and savings and loan associations was fully developed in hearings on the Revenue Act of 1962 last year.

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tee's terms of reference. The Committee has had indications, however, of particular cases of unduly lax supervision.[3]

The Committee has noted that a degree of national regulation is, in effect, provided by New York State, but there are inherent difficulties in regulation by individual States of companies that operate in many States. Furthermore, the setting of national standards may more properly be a function of the Federal Government. The Committee also noted that in the McCarran Act (1945), Congress provided that the antitrust laws would apply to the business of insurance "to the extent that such business is not regulated by State law." This provision raises questions as to the extent of applicability of the antitrust laws.

The Committee realizes that overriding but voluntary Federal chartering would be of only limited effectiveness in creating uniform regulatory standards across the Nation. In States where regulatory standards and entry requirements are relatively lax, Federal charters involving stricter standards would attract few companies. Only to the extent that life companies regard regulation by the States as too onerous or too divergent from State to State would Federal charters be attractive to individual companies and therefore effective in enhancing nationally uniform regulation.

The Committee also wishes to point out that, in view of the interstate character of the life insurance industry, problems of overly lax or disparate State regulation, if they arise, can be handled by specific Federal legislation, even in the absence of Federal charters.

Conclusion 10.—The Committee sees no objection in principle to voluntary Federal chartering of life insurance companies. At the same time, in view of the apparently lax supervision in some States, the inherent difficulties in State regulation of companies that operate across State lines, and the limited applicability of the antitrust laws, the Congress might wish to conduct a study of life insurance practices and regulation so as to determine whether Federal legislation is desirable.

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[3] The adequacy of supervision, State by State, is also discussed in *The Insurance Industry: Aviation, Ocean Marine, and State Regulation*, Report of the Committee on the Judiciary, U.S. Senate, made by its Subcommittee on Antitrust and Monopoly, 86th Cong., 2d sess., 1960.

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Chapter VI

INSURANCE OF DEPOSITS AND SHARES

The Federal Government provides insurance for deposits in commercial and mutual savings banks (through the Federal Deposit Insurance Corporation) and for shares in savings and loan associations (through the Federal Savings and Loan Insurance Corporation). All national banks, State-chartered member banks of the Federal Reserve System, and Federal savings and loan associations are required to be insured; State-chartered member associations of the Federal Home Loan Bank System are not required by law to carry insurance, but as a matter of policy the Federal Home Loan Bank Board does not currently admit associations to membership without insurance. For nonmember commercial banks, for mutual savings banks generally, and for State-chartered savings and loan associations, insurance is voluntary.

In fact, all but 2½ percent (or 329) of the commercial banks in the United States are insured by the FDIC. Uninsured banks account for less than 1 percent of all commercial bank deposits. Among the 515 mutual savings banks, 330 are insured by the FDIC (and 176 of those remaining are insured by the deposit insurance fund of the State of Massachusetts). Mutual savings banks not insured by either the FDIC or the Massachusetts fund account for little more than 0.1 percent of all mutual savings bank deposits. Among savings and loan associations, about two-thirds are insured with the FSLIC and they account for 95 percent of the assets of all associations.

Insurance coverage is presently $10,000 per account for deposits and shares. When introduced in the early 1930's, coverage was $2,500. This was raised to $5,000 in 1934 and to the present level in 1950.

Recommendations of Commission on Money and Credit.—The Commission recommended "that Federal deposit insurance for all savings banks and savings and loan associations be available from the Federal Savings and Loan Insurance Corporation, and that chartering authorities urge such participation."

The Commission's Report noted that savers frequently believe that their deposits and shares in all institutions are insured and that there are differences in the insurance available at various institutions. It suggested that insurance should be brought in line with savers' beliefs

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and practice. The Commission also suggested that the maximum insurance coverage per account should be reconsidered in the next few years.

Principal questions concerning insurance.—The Committee considered three principal questions in this area: (1) Should deposit and share insurance be compulsory, either for all or for a greater proportion of commercial and mutual savings banks and savings and loan associations? (2) Should the present $10,000 level be raised? (3) Should share insurance be available to credit unions?

Purposes of insurance.—In its deliberations on these questions, the Committee considered that the major purpose of deposit and share insurance is to preserve public confidence concerning the ability of financial institutions to meet their liabilities. This need was amply demonstrated historically by a series of financial panics in which suspension of payment by one or a few institutions was followed by "runs" on many sound institutions, which were in turn forced to close their doors. A related purpose of insurance is to prevent the economic disruption to communities that would result from the failure of banks or other financial institutions, with consequent losses to depositors and shareholders. Still another purpose is to protect the savings of families of moderate means, who often lack the technical ability to make judgments regarding the relative soundness of different institutions.

These purposes could conceivably be achieved in other ways. The central bank could presumably prevent panics and runs on financial institutions by committing itself to lend freely at such times. Effective examination and supervision, buttressing adequate portfolio regulation, might be relied upon to prevent most individual institutions from failing.

Yet the financial history of this country, with its structure of unit banks and other financial institutions, underscores the need for insurance protection in addition to the other governmental powers mentioned above. In any case, Federal insurance is by now an integral part of the financial landscape. Any suggestion that it be curtailed would act to undermine confidence and would serve no useful purpose.

Compulsory Insurance

The beneficiaries of deposit and share insurance—that is, consumers, businesses and institutions having accounts in insured institutions—do not contract directly for insurance. In this respect, such insurance differs from most other types of insurance protection. A depositor or shareholder protects his funds only by selecting an insured institution. But many citizens—especially those of small means who may

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be most in need of protection—lack the financial sophistication to be aware that some institutions are not insured. In fact, because such a large proportion of depositary institutions are insured, the public tends to assume that all are insured, with the result that funds may inadvertently be placed with uninsured institutions; this possibility has been enhanced in some instances by misleading advertising. For these reasons, a case can be made for compulsory insurance at all institutions.

There was sympathy for this viewpoint in the Committee. On the other hand, it was also felt that compulsion should be avoided if possible. In particular, when small local institutions choose to remain uninsured, their nearby depositors and shareholders are likely to be aware of their uninsured status. On this basis, the Committee believes that insurance need not be compulsory as long as uninsured institutions (commercial banks, savings and loan associations, and mutual savings banks), confined their operations to local areas.

Conclusion 11.—The Committee concludes, with one member dissenting, that uninsured commercial banks, mutual savings banks. building and loan, and savings and loan associations should be prohibited from accepting deposits or shares across State lines.[1]

The Committee affirms that institutions which benefit from Federal charters or membership in a Federal System ought to carry insurance.

Conclusion 12.—State-chartered savings and loan associations that are members of the Federal Home Loan Bank System but are not insured by the Federal Savings and Loan Insurance Corporation or an accepted State fund should either qualify for and obtain insurance from the Federal Savings and Loan Insurance Corporation or give up their membership. All new members should be required to obtain insurance.

The Committee is aware of the existence of State-sponsored insurance funds, with a history of sound operation. Institutions insured with State funds that have been in existence for a number of years should be exempt from the foregoing proposals. It is not desirable, however, to encourage the creation of additional State insurance systems. In view of the nature of the risks—which are not actuarially determinate—and in view of the fact that reduction of the risks depends in large part on actions by the Federal Government to prevent economic and financial crises, the provision of deposit and share insurance is properly a function of the Federal Government.

[1] The Committee is aware that a number of institutions are presently ineligible for Federal insurance by virtue of their form of organization. It is assumed that legislation to implement this conclusion would make provision for such problems.

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Limit on Insurance Coverage

If the purposes of insurance, outlined previously, are to be achieved and are considered overriding, a case can be made for complete coverage or a considerably higher upper limit than the present $10,000, especially for demand deposits. If the community needs protection against the economic disruption and hardship that would result from bank failures, this need is not fully met when the public can only count on protection of the first $10,000 in bank accounts. In order to be certain of full protection, depositors must split deposits among several banks and, for businesses especially, this is inconvenient and inefficient.

In the case of time deposits and shares, the justification for complete or much higher coverage is less compelling. These accounts are not transaction balances and, by definition, are not actively used. To split them among several institutions is less inconvenient and inefficient. Furthermore, it must be recognized that Federal insurance provides a distinct competitive benefit to savings institutions. It enhances their ability to attract funds which savers might otherwise invest directly and enables weaker institutions to compete on more equal terms with more carefully managed institutions. There is some question as to how far the Federal Government ought to go in abetting the promotional activities of savings institutions.

As a practical matter, however, the Federal Government through the FDIC could not provide higher insurance coverage for demand deposits than for time and savings deposits in the same institution. And, it could not provide higher coverage for time and savings deposits at commercial banks than for deposits and shares at other insured savings institutions.

A case can be made against complete insurance coverage on the ground that it would eliminate the incentive to holders of large accounts to investigate institutions before placing funds with them. This process is regarded by some as a desirable supplement to the activities of governmental supervisory authorities in preventing undue risk-taking by institutions. Others believe that governmental authorities can be relied on for this purpose and that the discipline exerted on management of financial institutions by large account-holders may lead to excessive avoidance of risk. One member of the Committee believes that an increase in insurance coverage would weaken the incentive to prudent management, particularly by those banks whose deposits would become fully insured.

In evaluating these various considerations, the Committee, with one member dissenting, agreed that increases in existing coverage are justified from time to time, to take account of rising income and wealth,

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among other factors, but that complete coverage of all deposits or shares should not be provided. Studies by the FDIC and the FHLBB have concluded that an increase to as much as $25,000 at the present time would be justified and helpful.

These studies, in particular, suggest that such an increase in coverage, judging from past experience, would have only a minor effect on the size of the FDIC and FSLIC insurance funds. For example, if coverage at $25,000 had been in effect during the past decade, net payments by the FDIC to cover depositors' claims on failed or failing banks over this period would have been about $270,000 or 11 percent higher, thereby reducing the size of the $2.4 billion fund by a minute fraction. Projections for the next decade prepared by the FDIC and FSLIC, taking into account the growth in deposits and shares but also assuming, for the sake of analysis, a considerably greater number of failures than in the past 10 years, indicate that an increase in coverage to $25,000 would reduce the projected size of each of the insurance funds a decade hence by much less than 1 percent.

The Committee is aware that it is impossible to forecast with reliability the amount of future drains on the insurance funds. One member believes that sufficient evidence has not been submitted to justify the proposition that insurance coverage could be substantially increased without raising the present assessment rates. Other members believe that the prospects for minimizing economic instability, together with the safeguards provided by bank supervision and examination, justify reliance on past experience in support of the judgment that insurance coverage can safely be increased while the current assessment rates are maintained.

Apart from this question, however, the Committee felt that proposals for increased insurance coverage could not appropriately be separated from consideration and evaluation of supervisory controls, adequacy of provisions for liquidity, and competitive practices in seeking funds, particularly as they may adversely affect lending standards among the various affected financial institutions, since increases in insurance coverage will, in the opinion of some, tend to reduce the care with which depositors or shareholders themselves evaluate the safety and stability of the various institutions, and thereby affect the ability of particular institutions to attract additional funds. The Committee has suggested several areas in which action is needed to strengthen further the supervisory framework and to assure more effectively the solvency and safety of individual institutions, including an extension of reserve requirements to savings and loan associations and mutual savings banks and a strengthening of the authority of supervisory authorities over liquidity positions.

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standby authority over rates paid on savings and time accounts, and broadening of safeguards against conflicts of interest to additional institutions. Consequently, the Committee, with one member dissenting, believes that an increase in insurance coverage would be appropriate when these other considerations—insofar as they are relevant to the kind of institution concerned—are satisfactorily resolved.

Conclusion 13.—The Committee, with one member dissenting, believes that an increase in existing insurance coverage is justified in terms of the adequacy and capacity of the insurance funds for meeting foreseeable contingencies. In considering such increases, however, the adequacy of liquidity, competitive practices in attracting funds as they are related to lending standards, and regulatory and supervisory controls and standards among the various affected financial institutions should be fully considered and continually evalulated.[3]

The various actions the FDIC may take to assist a failed or failing bank—such as making loans or purchasing assets to facilitate a merger or an assumption of assets and liabilities by another bank—are somewhat limited by the language of existing law. The Committee believes that the language should be modified so as to clarify the conditions under which the FDIC may take such actions to reopen or strengthen banks. One member of the Committee dissents on the grounds that this change would add to discretionary authority, which might not be uniformly applied.

Conclusion 14.—The Committee, with one member dissenting, favors a clarification of the conditions specified in the Federal Deposit Insurance Act under which the Corporation may assist a failed or failing bank.

Insurance for Credit Unions

Credit unions are the only depositary-type institutions that do not have insurance available through an instrumentality of the Federal Government. The Committee believes that before a decision is made to provide insurance, a thorough study should be undertaken to determine whether it would be consistent with the character, purposes, and functions of credit unions.

Although fast-growing and to some extent competing with other savings institutions, credit unions have unique characteristics. They do not serve the general public but are limited to accepting funds and making loans to members, who ordinarily have a common bond of

[3] One member, while agreeing to the general tenor of the statements in conclusion 13, does not consider it necessary to delay increasing the insurance limit to $25,000. Implementation of the other recommendations in this report would be timely enough even if such implementation followed the change in the insurance limit by as much as a year. Another member, who fully supports conclusion 13, points out that as far as his agency is concerned the aforementioned recommendations are already applied.

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occupation, association, or community. Furthermore, credit unions are frequently subsidized one way or another by employers and seldom have full-time management. Their loss experience has been very small.

The Committee is concerned that insured status might tend to change the character of credit unions so that some of them would become aggressive institutions that would use the insurance feature for promotional purposes. In order to assure preservation of the unique and useful status of credit unions, the Committee believes that neither cash reserve requirements nor Federal insurance should be adopted without more study.

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Chapter VII

STRUCTURAL CHANGES AND COMPETITION AMONG FINANCIAL INSTITUTIONS

In discharging its responsibility to assure that financial institutions remain both solvent and responsive to the needs of the community, the Federal Government inevitably is concerned with the structure of the markets within which financial institutions operate and compete. Federal agencies charter new institutions. They provide deposit or share insurance directly to federally chartered institutions and make such insurance available on a voluntary basis to institutions chartered by the States, thereby affecting their ability to compete. Generally, they approve or disapprove new branches, mergers, and holding company relationships among financial institutions, both Federal and State chartered. (For State-chartered institutions, approval of State supervisory authorities is required before action by the appropriate Federal agency is taken.)

These responsibilities give rise to administrative problems and to substantive policy problems. The administrative problems in this area represent one aspect, albeit a crucial one, of a more general problem regarding coordination of policy among Federal supervisory agencies with overlapping jurisdictions in the field of banking. This question is dealt with in Chapter IX of this report.

The substantive problems concern the standards to be applied in approving or disapproving structural changes, such as the chartering of new institutions, branches for existing institutions, mergers among existing institutions (which may either convert an independent institution into a branch of another institution or consolidate two or more offices into one), and holding company acquisitions.

Nature of Problem

In the period since World War II, the structure of financial institutions and their competitive relationships—especially in the field of commercial banking—have been subject to special stresses. Migration of people and businesses to the suburbs has led to a need for more varied lending and depositary services of banks and other financial institutions in areas where little such need was evident earlier. At the same time, more and more consumers have become bank depositors,

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and banks have had a greater incentive to compete for personal deposits. Growth in the size of business units has generated pressures for larger size banking units to serve business needs. The potential economies from use of automatic accounting and computing devices are providing a new inducement toward combination. In addition, general prosperity has apparently made it difficult for smaller financial institutions to hold and attract managerial talent.

The result has been a strong movement toward expansion, on the one hand, and toward consolidation, on the other. New institutions and, where permitted by State laws, new branches have been opened in many areas. At the same time, formerly independent institutions have been converted into branches by means of mergers. In the past decade 5,000 *de novo* branches of commercial banks have been opened, while more than 1,300 independent banks have been converted into branches through mergers. Holding company acquisitions and other forms of affiliation have also been widespread.

In recognition of the problems created by these developments, Congress has enacted two major laws in recent years. The Bank Holding Company Act of 1956 required prior approval by the Board of Governors of the Federal Reserve System of acquisitions of banks by holding companies. The Bank Merger Act of 1960 (an amendment to the Federal Deposit Insurance Act) specified the factors that Federal agencies were to consider in weighing a merger and emphasized the importance of considering the effect on competition, by providing that the agency having the responsibility to approve a merger should receive an advisory opinion on the competitive effect of the proposed merger from each of the other two banking agencies and the Department of Justice.

In deciding cases under these statutes and in approving or denying applications for new charters and branches, Federal agencies are necessarily exerting a major influence on the structure of financial institutions and the pattern of competitive relationships among them. Furthermore, decisions to grant charters and to approve branches, mergers, and holding company acquisitions are by their nature irreversible. It is important, therefore, that the criteria applied by Federal agencies be conducive to the type of financial structure that will over the years best serve the needs of a growing, efficient economy and that such criteria be consistently applied among the agencies involved and over time.

These criteria must take account of a great variety of local and regional circumstances, from small communities with a single bank to metropolitan centers with numerous giant financial institutions of all types. Policy approaches with regard to charters, branches,

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mergers, or holding companies that promote competition while encouraging soundness in one type of community or region might lead to excessive concentration elsewhere.

Nature of Financial Markets

Financial institutions, especially banks, operate and compete in circumstances that differ in several respects from those in which other businesses operate and compete.

In contrast to the situation that largely prevails in commerce and industry, the chartering of new financial institutions is subject to special limitations. The economic disruption and hardship that results from the failure of financial institutions has led governments to limit the establishment of new institutions in accordance with the "convenience and needs" of the community and with an eye to preventing the failure of the new or existing institutions.

Competition is also limited by other governmental restrictions. Regulation of interest rates paid by commercial banks reduces the extent to which banks may engage in price competition for demand, time, and savings deposits. For this and other reasons, competition often tends to be manifested in the nonprice elements of deposit relationships and loan contracts. Some portfolio restrictions also limit the area of competition.

Another feature is that the market in which financial institutions, especially banks, operate is difficult to define. In some of their loan and deposit operations banks serve a local market which may be sheltered from competition. In other transactions, they deal in national markets which are highly competitive. The absence of a single well-defined market complicates the task of judging the impact on competition of mergers and other structural changes.

Within finance, there is a significant degree of interindustry competition, which is relevant to decisions on structural changes. For example, banks compete not only with each other but with other types of savings and of lending institutions in attracting deposits and making loans and investments.

Although financial markets have special characteristics, including limitations on competition, it is important not to confuse banks and other financial institutions with public utilities. In the case of many public utilities, it is recognized that competition would be wasteful, and the discipline of competition is replaced by detailed governmental regulation of prices, types of service, etc. In finance, on the other hand, regulation is much less comprehensive. Considerable leeway exists for the play of competition and, in fact, competition is relied upon as a spur to adequate service and as a means of assuring that

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interest rates and other credit terms serve a useful allocative function on an equitable basis.

Recommendations of Commission on Money and Credit

The Commission recommended that—

1. The provisions of the National Banking Act should be revised so as to enable national banks to establish branches within "trading areas" irrespective of State laws, and State laws should be revised to provide corresponding privileges to State-chartered banks.

2. In exercising this power to grant branches, the chartering authority should adopt the following practices:

   a. It should avoid undue concentration of the local market.

   b. It should give new entrants a chance to compete even if their business must be partially bid away from existing competitors, and should place considerable reliance on the applicant's integrity, managerial competence, and his judgment in regard to the earning prospects of the new branch.

   c. It should treat the applications for new branches on a par with new unit bank applications.

   d. It should treat applications for new branches of nonlocal banks on a par with applications for new branches of local banks.

In its background discussion, the Commission expressed "its concern about the need for clarification of present legislation and diffusion of authority for administrative action in relation to financial mergers. At the same time, in its opinion, policy in regard to mergers should be discriminatng. Mergers that result in operating economies and which are forced by competition to pass on the benefits of operating economies clearly should be encouraged by public policy. The Commission's judgment is that more precise criteria than are now in use can and should be evolved for drawing the line between mergers that are and mergers that are not in the public interest."

Other Recommendation

The Advisory Committee on Banking to the Comptroller of the Currency recommended legislation that would permit national banks to establish branches within a limited area irrespective of the law of the State in which the national bank is located.

Needs for Study

As it considered the problems in this area, the Committee was aware of the difficulty of formulating reliable criteria on which policy decisions may be based. In contrast to many of the items within the

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Committee's terms of reference, which have been the object of analysis and recommendation over the years, the issues pertaining to industrial organization, performance, and market structure among financial institutions have received little systematic study. Yet Federal agencies must act on a steady stream of applications for structural changes. The Committee urges that strong encouragement be given to research efforts, within the Federal Government and elsewhere, aimed at evaluating the performance of financial institutions with different types of structure and at studying the interaction between performance and structure.

Conclusion 15.—The Committee urges that intensive studies be undertaken, within the Government and elsewhere, with a view to providing an essential body of information and analysis on which to base sound policy guidelines for decisions on applications for charters, branches, mergers, and holding company acquisitions.

Structural Changes and Competition Among Commercial Banks

Statutory standards.—The Federal statutes authorizing charters for national banks, branches for national and insured State banks, admission to deposit insurance, and admission to membership in the Federal Reserve System specify a number of factors that the supervisory agencies must take into account before acting. In general the so-called "banking" factors, which the agencies are required to consider before acting on an application, include the financial history and condition of bank (or banks), capital adequacy, future earning prospects, character of management, corporate powers, and the convenience and needs of the community. The more recent legislation on bank holding companies and mergers includes similar factors but also explicitly adds "the effect on competition" as a factor.

It is clear, from legislative history and regulatory practice, that each of these factors is not necessarily given equal weight. In particular, the effect on competition, although it is only one of seven factors specified in the Bank Merger Act, is accorded substantial weight. Frequently, the problem facing the supervisory agency with primary responsibility is to balance the combined banking factors against the competitive factor.

Some members of the Committee believe that even greater weight should be given to the competitive factor than has been the practice in the past, and they would achieve legislative support for this objective by reducing the number of factors to three: banking soundness, convenience and needs of the community, and effect on competition. Other members of the Committee believe that such a change would serve no purpose and that the present statutes give adequate emphasis to the competitive factor.

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Consistency of standards.—The market environment in which banks compete is affected by each of the four types of structural change over which the Federal Government has supervisory authority. Yet the statutes do not lay down completely consistent standards as a basis for decisions by supervisory authorities. In particular, although the effect on competition is specified as a relevant factor in merger and holding company cases, the statutory authority to grant charters and branches does not require that the effect on competition be considered.

In practice, the supervisory authorities tend to apply the same standards to charter and branch applications as to merger and holding company requests. The Committee believes that this practice is appropriate. It was observed, for example, that the establishment of new branches may not always enhance competition. Where the alternative to a new branch of an existing institution is a new independent institution, competition might be greater if the branch application is denied and the charter application is approved.

The Committee differed on whether or not the practice of supervisory agencies in applying the competitive factor to charter and branch applications should receive explicit statutory endorsement. Some members believe that this is unnecessary, in view of existing practices. A majority favors legislative authorization for the practice of basing decisions on charter and branch applications on "the effect of competition" along with the criteria already specified by law. The result would be that each of the supervisory agencies would be directed to apply similar, if not identical, standards to each type of significant structural change—charters, branches, mergers, holding company acquisitions and any other form of affiliation which might be regulated.

Conclusion 16.—Although existing statutory standards are interpreted as authorizing consideration of the effect on competition in the granting of charters and the approval of new branches, the Committee concludes that the statutory standards applicable to granting of charters and approval of new branches should explicitly include "the effect on competition."

In addition to the need for consistency in evaluating different types of structural changes, application of standards among the several supervisory agencies should be consistent. Whether or not the Federal agencies have been consistent in their decisions is a matter of some disagreement.

The general problem of uniformity in bank supervision at the Federal level is discussed in chapter IX of this report. The need for specific measures to encourage greater uniformity in decisions on bank

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structure depends on what action is taken with regard to coordinating bank supervisory functions generally.

A degree of coordination is achieved in merger cases by the provision of the law that each of the other bank supervisory agencies and the Justice Department submit to the agency responsible for decision an advisory opinion on the effect of the proposed merger on competition. Some members of the Committee see merit in a proposal that this procedure be extended, on a permissive basis, to other types of structural change, including charters, branches, holding company acquisitions, membership in the Federal Reserve System, and admission to deposit insurance. Thus each supervisory agency and the Department of Justice would be given notice of applications received and would have an opportunity to submit an advisory opinion on the effect of such proposed actions on competition. It would be understood the agencies would not be required or expected to submit advisory opinions in the case of each application, but only when they had a substantial reason for doing so. Other members oppose this proposal on the grounds that such interchange would be needlessly burdensome.

As an alternative to this coordination procedure, and pending more general decisions with regard to bank supervision, some members of the Committee favor establishment of a single board (consisting of representatives of each of the three bank supervisory agencies) to act on all applications for charter, branch, merger, or holding company acquisition. Other members believe that the arrangements for informal coordination which have generally prevailed in recent years are satisfactory and adequate.

Conclusion 17.—The Committee believes that in the case of each application for charter, branch, membership in the Federal Reserve System, and admission to deposit insurance, the banking agencies not directly concerned and the Justice Department should have the opportunity to submit an advisory opinion on the effect of the proposed action on competition.[1]

Branching problems.—In considering the recommendations concerning branches of national banks that have been put forward by the Commission on Money and Credit and by the Advisory Committee on Banking to the Comptroller of the Currency, the Committee was well aware of the controversial and emotion-laden aspects of this issue.

In the case of banks, the Congress has taken the position that State laws should remain paramount in determining the branching privileges of both State- and Federal-chartered banks. In the case of

[1] Three members dissent on the grounds that this conclusion would place new and burdensome responsibilities on the affected agencies and create unnecessary confusion concerning the locus of responsibility and the standards to be applied in an area in which adverse competitive implications are seldom a critical factor.

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Federal savings and loan associations, however, the Federal statutes impose no limitations on the authority of the Federal Home Loan Bank Board to grant branching privileges.

Under existing law, branch banking is completely prohibited in eight States. An additional eight States prohibit branches with limited exceptions, such as drive-in facilities close to the main office or paying and receiving stations in communities without established banking facilities. At the other extreme, branching is authorized without local limitation in 10 States. In the remaining States, branch banking is permitted under varying limitations. Where limited branching is permitted, the statutes in most States are more liberal regarding branches near the main office than for more distant branches.

The Committee believes that extreme limitations on authority to permit branching by commercial banks in some States may operate to the detriment of the interest of businesses and consumers in those States. In other States, relatively unrestricted authority to permit branching may have led to excessive concentration of banking facilities. Leaving aside considerations involving the relationship between the Federal and State Governments, it is difficult to defend the extreme disparity among the States in the prevalence of branch banking. It is likely that the public interest would be better served by a more consistent policy among the States regarding branches.

An argument in favor of permitting banks to establish branches more freely is that it brings some of the benefits of economies of scale to users of banking services in areas which cannot support large unit banks or perhaps any unit bank. In addition, the establishment of new branches can sometimes increase competition and thereby improve and lower the cost of banking services.

A major disadvantage attributed to broad statutory authority for branching is that, unless carefully administered, it can lead to undue concentration of banking facilities. It is also argued that independent unit banks are more responsive to the needs of the local community. Finally, it may be argued that in some areas a freer chartering policy by supervisory authorities would introduce more competition without the additional concentration that comes with branching.

One way to work toward a more uniform approach to branching is through the branching authority for national banks. Opinions differ on whether the economic advantages from such an approach would be great enough to warrant disturbing the existing balance between Federal and State supervision. It is certain that considerable controversy would ensue if it were proposed that the Federal Government permit national banks to establish branches in areas where this is not presently permitted to State-chartered banks.

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Conclusion 18.—The Committee believes that extreme limitations on branching of financial institutions in some States may impede the provision of banking services and effective competition. On the other hand, it is important to avoid excessive concentration of banking (and other financial) facilities through branching. It seems quite likely that branching, properly regulated, can encourage more favorable competitive conditions and the provision of more effective banking services, particularly in local areas, without affecting the soundness of banks (and other financial institutions). The Committee concludes therefore that the Federal and State Governments, within their respective authorities, should review present restrictions on branching with a view to developing a more rational pattern, subject to safeguards to avoid excessive concentration and preserve competition.

Other forms of affiliation.—At present, only branching and bank holding company relationships are subject to Federal supervision. There are, however, other forms of affiliation among banks and other financial institutions which may require supervision. The Committee has in mind widespread instances of ownership of two or more banks by individuals, sometimes referred to as chain banking. The Committee believes that additional studies are needed to determine whether such other forms of affiliation require Federal supervision.[2]

Structural Changes and Competition Among Savings and Loan Associations

The Committee believes that federally supervised savings and loan associations and mutual savings banks should be subject to Federal standards regarding charters, branches, mergers, and holding company supervision similar to those applicable to commercial banks, as discussed previously. This would include authority to the Federal Savings and Loan Insurance Corporation to pass on application for branches of State-chartered associations in a manner parallel to the authority of the Federal Deposit Insurance Corporation over State banks.

Federal law, as noted, does not limit the authority to permit Federal associations to branch. As a matter of policy, however, the Federal Home Loan Bank Board follows the principle of permitting branches for Federal savings and loan associations in any locations where State laws permit (or do not prohibit) other financial institutions to have some form of affiliate office. Pending outcome of the decision on branch banking, the Committee does not suggest a change in either the legislation or the policy regarding branches of Federal savings and loan associations.

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[2] One study of this type has recently been published: *Chain Banking*, Report by Wright Patman, chairman, to the Select Committee on Small Business, House of Representatives, 87th Cong. (Jan. 3, 1963).

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Conclusion 19.—In principle, the Committee believes that federally supervised savings and loan associations should be subject to Federal standards regarding charters, branches, mergers, and holding company supervision similar to those applicable to banks. However, pending outcome of the study on branching recommended above, the Committee does not suggest a change in either the legislation or the policy regarding branches of Federal savings and loan associations.

Conclusion 20.—The Committee believes that the Federal Savings and Loan Insurance Corporation should be given authority to pass on branching applications of State-chartered insured associations in a manner parallel to the authority of the Federal Deposit Insurance Corporation over insured State banks.

Interlocking Relationship Among Financial Institutions

Section 8 of the Clayton Act has two parts. The first part, which applies only to banks, prohibits (with exceptions) interlocking relationships between member banks of the Federal Reserve System and other banks in the same or a nearby community. But interlocking relationships among nonmember banks, savings and loan associations, and other financial institutions are not covered by the law. Mutual savings banks are explicitly exempted, as are relationships involving a member bank if the banks are not located in the same or a "contiguous" or "adjacent" city, town, or village. The Committee sees no reason why these limitations on interlocking relationships should apply only to member banks.

Although the second part of section 8 deals with corporations in general, it contains a reference to banks and is therefore pertinent to the work of the Committee. That part of the section prohibits interlocking directorates between two or more *competing* corporations engaged in commerce (if one has a capitalization above $1 million). There is an exemption, however, for "banks, banking associations, [and] trust companies." This exemption was presumably inserted in order to omit from coverage of the second part of section 8 those relationships among banks already covered by the first part. It might be interpreted, however, as exempting an interlocking directorate between a bank and a competing financial institution even though the latter type of interlocking relationship is not covered by the first part of section 8. The Committee believes that the Clayton Act needs clarification in this respect.

Conclusion 21.—The Committee believes that the provisions of section 8 of the Clayton Act which govern interlocking relationships involving financial institutions should be clarified and probably strengthened.

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Chapter VIII

CONFLICTS OF INTEREST

The Commission on Money and Credit recommended that, in view of the rapid postwar growth of financial institutions, existing legislation, regulations, and examination procedures be reviewed "to ensure against any unwarranted personal benefits accruing to individuals responsible for handling institutional funds, which might be associated with or derived from the use or investment of the funds."

This is a matter on which the Committee was not in a position to make an intensive examination. The Commission's recommendation refers not to violations of existing law but to inadequacies in law and regulation, including the extent of their applicability, which might permit unwarranted personal benefits by reason of association with financial institutions. For example, officers, directors, or employees of financial institutions may have other business interests (such as insurance or real estate) to which direct benefits accrue as a result of their association with the financial institutions.

Legislative restraints are more stringent for some types of financial institutions than for others. The Federal statutes contain a number of limitations on transactions between member banks and their officers and directors and also between member banks and affiliated organizations. Also, certain criminal statutes relating to conflicts of interest are applicable to directors, officers, and employees of insured banks. But the Federal statutes pertaining to savings and loan associations do not include all the safeguards contained in the Federal banking laws.

Conclusion 22.—The Committee believes that the safeguarding provisions now applicable to either member or insured banks should be broadened so as to apply to all commercial banks, savings and loan associations, mutual savings banks, and credit unions subject to Federal supervision. They should also be made more effective—for example, by strengthening the definition of affiliated organizations and by extending the class of transactions that are limited or prohibited. At the same time, these provisions might be made more equitable (for example, by increasing the present ceiling of $2,500 on the amount an executive officer of a bank may borrow from his bank and by permitting public bank examiners to obtain mortgage loans from an insured bank on real estate that they occupy as residence).

More generally, consideration should be given to authorizing supervisory agencies to issue regulations, as they deem it necessary, to prevent unwarranted benefits to individuals from their association with financial institutions.

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Chapter IX

SUPERVISION AND EXAMINATION OF FINANCIAL INSTITUTIONS

This chapter is concerned with the organization within the Federal Government of supervisory activities over private financial institutions. These activities are presently performed by three Federal agencies in the case of commercial banks and by one agency each in the case of mutual savings banks, savings and loan associations, and credit unions. It should be noted at the outset that in its deliberations the Committee assumed continuation of the so-called dual system of banking and finance, with its division of supervisory and chartering responsibilities between the Federal and State governments.

The Federal supervisory agencies and their major present functions are as follows:

The Office of the Comptroller of the Currency, in the Treasury Department, charters, supervises, and examines the 4,500 national banks and approves new branches and mergers in which the resulting institution will be a national bank.

The Federal Deposit Insurance Corporation provides insurance to national and State-chartered banks that are members of the Federal Reserve System, and admits to insurance State nonmember commercial and mutual savings banks that apply and qualify for insurance. The Corporation regularly examines the 7,000 insured nonmember commercial banks and the 331 insured mutual savings banks. New branches of insured nonmember banks and mergers, where the resulting bank is an insured nonmember, require the approval of the Corporation.

The Board of Governors of the Federal Reserve System, in addition to its central banking functions, admits State-chartered banks to membership in the Federal Reserve System and examines State member banks. Branches and mergers, where the resulting institution will be a State member bank, and the acquisition of any bank by a holding company require the approval of the Board. (Membership in the System includes the 4,500 national banks and 1,570 State banks.)

The Federal Home Loan Bank Board charters, supervises and examines Federal savings and loan associations; provides insurance, through the Federal Savings and Loan Insurance Corporation, and

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examines State-chartered insured and member associations; also it provides advances to member associations through the Federal home loan banks. Branches and mergers involving Federal associations require the approval of the Board. (Membership in the System consists of 1,900 Federal associations, 2,900 State-chartered associations of which 2,300 are insured by the FSLIC, and 20 mutual savings banks.)

The Bureau of Federal Credit Unions, in the Department of Health, Education, and Welfare, charters, supervises, and examines the 10,000 Federal credit unions.

Recommendations of Commission on Money and Credit.—The Commission recommended "increased coordination of examining and supervisory authorities. At the Federal level there should be only one examining authority for commercial banks. The Comptroller of the Currency and his functions and the FDIC should be transferred to the Federal Reserve System." The Commission also recommended "that there be a unified authority at the Federal level for the examination of all federally insured savings and loan associations and mutual savings banks. The activities and standards of these two Federal authorities should be coordinated with each other and with the respective State examining and supervisory authorities."

Four members of the Commission appended footnotes endorsing consolidation but questioning whether the responsibility should be shifted to the Federal Reserve. Another member favored consolidating bank supervision in the FDIC.

Other proposals.—In recent speeches, Gov. J. L. Robertson of the Federal Reserve Board has proposed that a new Federal banking commission be established to take over all the bank supervisory functions of the three agencies. The Federal Reserve would confine itself to monetary policy and the functions of the other two bank supervisory agencies would be transferred to the new commission. This new agency would have two major divisions, one to deal with insurance and the other to deal with examination, changes in bank structure, and related matters.

Chairman Cocke of the FDIC has suggested in a recent speech that the Federal Reserve should be relieved of responsibility for bank supervision and that the FDIC, as insurer, should examine all insured banks, alternating examinations with the Comptroller of the Currency in the case of national banks and with State authorities in the case of State banks. The FDIC would investigate, concurrently with the Comptroller or the State chartering authority, proposals for changes in bank structure.

The Advisory Committee on Banking to the Comptroller of the Currency recommended recently that the Federal Reserve be divested

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of all nonmonetary functions and that all supervisory, examination. and regulatory authority relating to national banks be transferred to the Comptroller of the Currency. All Federal supervisory, examination, and regulatory authority over State-chartered banks would be transferred to the FDIC, but authority to approve branches of State banks would be relinquished to the State supervisory authorities. The FDIC would be reorganized under a single administrator and transferred to the Treasury Department.

Committee's approach to supervision problems.—The Committee first examined the working of the present tripartite organization of Federal bank supervision. Finding that differences in approach and deficiencies in coordination are possible under the existing arrangement, the Committee went on to examine the advantages and disadvantages of a more unified approach to Federal bank supervision.

The Present System of Federal Bank Supervision

The existing organization of bank supervision at the Federal level is the result of historical evolution. The National Bank Act (1863) established the Office of the Comptroller of the Currency as supervisor of national banks. From 1863 to 1913, there was a clear and complete division of authority, without overlap, between Federal supervision of national banks and State supervision of all other banks.

With the creation of the Federal Reserve System in 1913, national banks became subject to supervision by the Federal Reserve as well as by the Comptroller, and State banks that chose to join the System became subject to some measure of Federal supervision. Finally, with the introduction of deposit insurance in 1933, nonmember State banks came under Federal supervision (by the FDIC) if they chose to be insured, while both National and State member banks, for which insurance is mandatory, acquired a relationship with a third Federal supervisory agency. At the same time, State-chartered banks, whether members or nonmembers of the Federal Reserve System, and whether insured or not, continued to be supervised by State authorities. It has turned out, therefore, that the only group of commercial banks not subject to some measure of multiple supervision are the 300 uninsured banks, out of a total of about 13,400 commercial banks.

The system of overlapping supervision of commercial banks has been made workable by a division of jurisdiction and by procedures for coordination. Primary responsibility for Federal supervision and examination has been apportioned by law as follows: national banks by the Comptroller of the Currency; State member banks by the Federal Reserve; and insured nonmember banks by the Federal Deposit Insurance Corporation. Yet each agency continues to have

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functions affecting banks primarily under the jurisdiction of one or both of the other agencies.

The three agencies perform some similar functions. Each examines and each approves branches and mergers. Over the years, various techniques, formal and informal, have been developed to facilitate coordination. Each agency has access (in some cases by statute) to the relevant examination reports of the others, and such reports have been standardized to a large extent. Under the Bank Merger Act of 1960, each agency plus the Justice Department is required to render to the agency with primary responsibility an advisory opinion on the effect of each proposed merger on competition among banks. Over many years, although not currently, all three agencies had exchanged full information and views on charter and branch applications and had jointly operated a school for bank examiners.

Advantages of Present System

The existing organization of bank supervisory functions at the Federal level is defended on the grounds that (1) it prevents abuses that might result from concentration of authority in a single Federal agency; (2) it reflects differences in function, which call for separation of authority; and (3) coordination among the three agencies can prevent inconsistent policies and duplication.

1. It is frequently argued that division of responsibility for bank supervision among three agencies has the advantage of diffusing power and therefore lessening the possibility of arbitrary action by government officials. A related argument is that the existence of more than one supervisory agency provides financial institutions an opportunity for relief from arbitrary or unduly stringent regulation.

A counter-argument is that this is not an appropriate way to provide for relief from arbitrary or unduly stringent regulation, where and when it exists. It is the rule rather than the exception for supervisory and regulatory functions to be concentrated in one agency. For example, there is a single Federal supervisory authority over insured savings and loan associations, railroads, communications companies, etc. Furthermore, if the principle implied by the above argument were generally followed, it would require multiplication of supervisory agencies with similar functions in other areas.

2. A major consideration advanced in favor of multiple supervision is that since the functions of the agencies are distinct, they can be more effectively conducted on a separate basis. In a dual banking system, the nature of Federal supervision over State banks is quite different from that over national banks and calls for separate treatment. For example, it is argued that unless there is complete separa-

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tion between the chartering and insurance authority, a danger exists that the Federal insuring authority will favor federally chartered over State-chartered institutions.

In opposition to this viewpoint, it is argued that under the present arrangement no agency has authority commensurate with its responsibilities. For example, the FDIC has no discretion whether or not to provide insurance to National and State member banks; its authority extends only to insure nonmember banks. It is also observed that both the Federal Reserve and the Federal Home Loan Bank Systems supervise Federal and State-chartered institutions, and there is no reason to believe that they show favoritism.

3. The third major defense of the present arrangement is that machinery for coordination eliminates duplication and the danger of differences in policy approach. As noted earlier, various procedures, both statutory and informal, have been developed over the years to encourage coordination and these procedures have ordinarily accomplished their major purposes.

A counter-argument is that, since much of this coordination is voluntary, it cannot always be counted on to be successful. Moreover, it may involve an undue expenditure of time and effort by executives and staff of the three agencies.

Disadvantages of Present System

Some of the problems in the existing arrangement are noted in the previous section. The other major disadvantages attributed to the present tripartite system are that (1) it makes possible differences in supervisory policy and practice between one group of banks and another; (2) it makes possible a degree of rivalry among supervisory agencies; and (3) it is illogical and inefficient.

1. The Committee's discussion brought out the possibility of differences in policy approach. The major policy questions currently facing the three agencies are in the field of bank mergers. The Bank Merger Act of 1960 specifies seven factors to be considered by the responsible agencies when they judge applications; six of these are so-called banking factors and the seventh is the effect on competition. The Merger Act requires advisory opinions from the other two banking agencies and the Department of Justice only on the effect of the proposed merger on competition, while the agency with primary responsibility must weigh not only this but all the factors specified by Congress. But the act does not and cannot provide specific guidance, and differences in approach are possible. Although the Committee is aware that a pattern of decisions under the 1960 legislation may be in process of evolution, it is conceivable that mergers would be more freely per-

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mitted among banks under one jurisdiction than under another, with unfortunate and irreversible results.

2. A second disadvantage of the existing organization is that there is a possibility of rivalry among the agencies, involving competition to attract banks that are under the jurisdiction of one of the other agencies. Such rivalry could, in turn, lead to a competitive lowering of regulatory standards.

3. Finally, it may be argued that even if a division of authority were desirable, the present demarcation cannot be defended on any logical basis. In particular, division in Federal examining authority over insured State-chartered banks between the Federal Reserve and the FDIC seems hard to defend.

Committee Analysis

The Committee recognizes that the present arrangement makes possible lack of uniformity in Federal bank supervision. It is clear that the degree of uniformity has varied from time to time depending on the views and temperaments of the responsible officials.

At the very least, procedures for coordination should be strengthened. One way to accomplish this would be to replace the informal methods of coordination with statutory requirements. In the area of charters, branches, mergers, and holding companies, the Committee is making specific recommendations (in Chapter VII) for greater opportunity for interchange of advisory opinions among the three agencies. Although the procedures recommended in Chapter VII are designed to encourage more consistent policies with regard to bank structure changes, those procedures would increase the duplication of effort that now exists. Furthermore, although the rendering of advisory opinions may encourage, it does not assure, uniformity of policies.

As another step, the Committee considered the pros and cons of reducing to two the number of bank supervisory agencies, by removing the Federal Reserve from the field of bank supervision. As noted, Governor Robertson of the Federal Reserve included the latter suggestion in his proposal for a single agency, and both Chairman Cocke of the FDIC and the Advisory Committee to the Comptroller of the Currency have put forward proposals for a two-agency system of Federal bank supervision. Chairman Cocke proposed that the FDIC take responsibility for Federal supervision of all insured State banks and that it share with the Comptroller examination and some supervisory functions over national banks. The Advisory Committee to the Comptroller recommended a complete separation of these functions, with the FDIC having sole responsibility for Federal supervision of insured

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State banks and the Comptroller having sole responsibility over national banks, but with both under the general supervision of the Secretary of the Treasury.

These proposals would clearly eliminate some of the disadvantages of the existing arrangement. Both would end the division of responsibility for Federal supervision of insured State-chartered banks. and the Advisory Committee proposal would also accord full responsibility for the supervision of national banks to a single agency. General supervision of both agencies by the Secretary of the Treasury, as recommended by the Advisory Committee to the Comptroller, would reduce the scope for divergence in policy approach. Neither proposal for two agencies would, however, automatically eliminate the possibility of differences in treatment for particular groups of banks.

The two-agency proposal would have the additional advantage of permitting the members of the Federal Reserve Board to concentrate their time and energies on their principal responsibility—the formulation and implementation of monetary policy. There may be disadvantages, however, in removing the Federal Reserve from the field of bank supervision. Although its main task is monetary policy, the central bank is also vitally concerned with the soundness, flexibility. and competitive structure of the commercial banking system. These characteristics of the banking system can significantly affect the transmission of monetary policy actions to the economy at large. Furthermore, the intimate knowledge of banking conditions that comes from examination and supervision is very helpful, if not essential, to the effective conduct of monetary policy.

The Committee also gave consideration to unifying Federal bank supervision in a single agency. Such a proposal would cope with most of the disadvantages in the present system. It would facilitate execution of consistent and uniform policy with respect to banking structure changes. It would end the possibility of rivalry among Federal agencies and eliminate the time and effort now devoted to the machinery for coordination. Such an agency would represent the focal point of Federal responsibility for bank supervision in the eyes of the President, the Congress, and the general public, as well as the banks subject to supervision.

Locus of responsibility.—Even those who favor such consolidation find it is easier to state the advantages of a single supervisory authority than to determine the most desirable locus for that authority.

The FDIC has a broad base among commercial banks. It now insures over 97 percent of all commercial banks and has cooperative arrangements with the State bank supervisory authorities. It would therefore be a logical repository for all Federal supervisory functions.

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However, an agency with an insurance function might be so concerned with protecting the insurance fund that overly strict supervision of banks would hamper innovation and growth. In addition, the FDIC is publicly identified with State nonmember banks and its selection as the single supervisory agency might be taken—regardless of merits—as a threat to the national banking system.

Another possibility would be to accept the recommendation of the Commission on Money and Credit that all Federal supervisory responsibilities over commercial banks be transferred to the Federal Reserve. The Federal Reserve is not historically identified with either national or State banks and has broader responsibilities than bank supervision. Moreover, as noted earlier, the central bank has a strong interest in the structure of the banking system.

The major disadvantage is that even the present supervisory tasks of the Board interfere with its main responsibility. How much that interference would increase compared with the present arrangement is not clear. But, as noted earlier, a case can be made for relieving the Board of bank supervision and lessening that interference. An alternative would be to center the supervisory task at the Federal Reserve but to change its organization, by statute, to provide for the delegation of responsibility for bank supervision to individual Board members or to senior staff. (Indeed, this might be desirable even if the Board retains only its present responsibilities.)

Finally, there is the possibility of creating a new agency to incorporate the supervisory functions now vested in the Comptroller, the Federal Reserve, and the FDIC (which could be transferred as a corporate entity to the new agency). The major consideration against creation of a new agency devoted only to bank supervision is the danger that it might come to be identified with, or even dominated by, the industry it supervises. Some have contended that unification of Federal bank supervisory functions might be interpreted as a threat to the dual banking system. But experience with a single Federal supervisory agency in the case of savings and loan associations does not support this contention.

On the favorable side, such an agency would have the advantage of starting with a clean slate, without traditional identification with a particular segment of the commercial banking system. A new agency could be made a part of the Treasury Department, where it would have the advantage of access to the Cabinet through the Secretary, or it could be given independent status, which might enhance its ability to attract officials of the highest calibre.

Conclusion 23.—The Committee concludes that practices of bank supervisory and examining agencies in the Federal Government have

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not always been fully satisfactory in achieving needed cooperation and coordination.[1]

Existing agencies should strive to achieve greater cooperation and coordination under common standards, regulation and procedures, than has been achieved in the past. Reviews should be made, however, at the discretion of the President, to determine whether this approach is proving successful in anticipating and resolving major common problems. If the reviews indicate that important public purposes in this area still are not being achieved, consideration should then be given to more basic approaches, such as consolidation of bank supervision in the hands of two agencies, or a single agency or commission.

Federal Supervision of Other Financial Institutions

In the case of savings and loan associations, Federal supervision is organized in a single agency. Examination, regulation, and insurance are all concentrated in the Federal Home Loan Bank Board, which manages the Federal Savings and Loan Insurance Corporation. The Committee does not recommend that this arrangement be altered in any fundamental way.

It has been proposed that, should Federal charters be made available to mutual savings banks, the Federal Home Loan Bank Board be designated as the supervisory authority. This would also involve insurance. The result would be that the Federal Home Loan Bank Board would be supervising two types of institution; furthermore, the question would then arise whether State-chartered but federally insured mutual savings banks should remain under the jurisdiction of the Federal Deposit Insurance Corporation. The Committee has no solution to these organizational problems but regards them as relevant if and when consideration is given to the proposal for Federal charters.

The Committee has no comment regarding supervision of Federal credit unions.

On the question of coordination between agencies supervising commercial banks, on the one hand, and other financial institutions, on the other, as recommended by the Commission on Money and Credit, there is no reason why such coordination cannot be worked out on an informal basis, as needed. Such coordination would become especially relevant if the Committee's recommendations on cash reserve requirements at mutual savings banks and savings and loan associations and on standby regulation of interest and dividend rates are implemented.

[1] Four members believe that not only the practices but the organization of bank supervision is not fully satisfactory.

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Conclusion 24.—The Committee concludes, in the interest of improved coordination and implementation of Federal laws, regulations and policies affecting all federally supervised financial institutions (including savings and loan associations and credit unions), that the Federal chartering, supervisory and insuring agencies should meet at regular times, at less than quarterly, to discuss and resolve matters of current or mutual interest.

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APPENDIX

THE WHITE HOUSE,
Washington, March 28, 1962.

Memorandum to:

The Chairman of the Council of Economic Advisers.
The Secretary of the Treasury.
The Attorney General.
The Secretary of Agriculture.
The Director of the Bureau of the Budget.
The Chairman of the Board of Governors of the Federal Reserve System.
The Chairman of the Home Loan Bank Board.
The Administrator of the Housing and Home Finance Agency.
The Comptroller of the Currency.
The Chairman of the Federal Deposit Insurance Corporation.

Subject: The Establishment of a Committee on Financial Institutions.

Pursuant to my Economic Report to the Congress, I am requesting the persons to whom this memorandum is addressed to form a Committee on Financial Institutions to review legislation and administrative practice relating to the operations of financial intermediaries. I am asking the Chairman of the Council of Economic Advisers to serve as Chairman of this Committee. The Committee should seek the views and advice of appropriate Government agencies and may also consult with interested private parties and independent experts.

The recommendations of the Commission on Money and Credit on this subject provide a point of departure for the Committee, but its deliberations need not be limited to the issues raised by the Commission. The Nation's monetary, credit, and financial system makes important contributions to the functioning of our free enterprise economy and to the effectiveness of Government policies under the Employment Act of 1946. The general task of the Committee is to consider what changes, if any, in Government policy toward private financial institutions could contribute to economic stability, growth, and efficiency. Recommendations for changes should provide for equitable treatment of the various types of financial institutions and for transitional arrangements that may be necessary to minimize any temporary disruptive effects.

Among the topics for consideration by the Committee should be the following:

(a) The scope of controls over commercial banks and other financial intermediaries exercised by the Federal Reserve System and other governmental and quasi-governmental agencies: for example, membership in the Federal Reserve System and in the Federal Home Loan Bank System, reserve requirements, regulation of interest rates on deposits and other liabilities and on Government-guaranteed mortgages.

(b) The possibility and desirability of broadening the permissible portfolio choices of various kinds of financial institutions.

(c) The scope of Federal deposit and share insurance programs: criteria for voluntary and compulsory participation.

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(*d*) Federal chartering of financial institutions: life insurance companies, mutual savings banks.

(*e*) Federal legislation with respect to branching of banks and other financial intermediaries.

(*f*) Coordination and possible consolidation of Federal responsibilities for supervision, examination, and chartering of financial intermediaries and for regulation of merging and branching.

(*g*) Adequacy of legislation and regulations to insure against unwarranted benefits to individuals handling funds for financial institutions.

In order to be of use in drawing up the Administration's legislative program for the 1963 session of the Congress, the Committee's report and recommendations should be submitted to me by November 30, 1962.

I am enclosing for your information copies of the memoranda establishing separate committees on Corporate Pension Funds and Other Private Retirement and Welfare Programs and Federal Credit Programs.

(S) JOHN F. KENNEDY.

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COMMENTS BY THE FEDERAL RESERVE BOARD STAFF ON A PAPER BY MYRON H. ROSS ENTITLED "OPERATION TWIST: A MISTAKEN POLICY"[1]

Most critics of "Operation Twist" have concentrated their attacks on the point that it is not possible significantly to alter the term structure of interest rates by changing the maturity composition of the federal debt.[2] Several empirical studies have lent some support to this criticism. Mr. Ross' paper takes a different line of attack. He *assumes* that U.S. financial policies actually led to a twist in the rate structure[3] and then goes on to inquire whether this twist may have had domestic costs which exceeded the intended external benefits.

Given his premise that Operation Twist did successfully alter the yield curve from what it otherwise would have been, Ross' argument is an interesting one. He contends that domestic inventory investment is interest-sensitive and that, under certain assumptions about the relative interest-elasticity of inventory investment as opposed to investment in fixed assets, the net effect of a rise in short rates and a fall in long rates that leaves the size of the federal debt unchanged would be to decrease aggregate investment demand. Against these estimates of the potentially large domestic costs (i.e., lower output and employment during a time when the policy objective was to expand aggregate demand), Ross contrasts an estimate of the external benefits (improvement in the balance of payments on short-term capital account). His calculations of the impact of Operation Twist on the balance of payments are based on some research results of Jerome Stein;[4] Ross interprets Stein's estimates as showing only a "very small" improvement (very small relative to the domestic costs). Ross' calculations thus lead him to the conclusion that the *net* benefits of Operation Twist were probably negative.

It is important to note that all of Ross' calculations are based on purely hypothetical examples. The absolute magnitudes of the numbers in his paper (for example, the $154 million annual improvement in the balance of payments) are not, nor does Ross intend them to be, measurements of actual costs and benefits. His procedure is *to assume* that there is a 10% rise in short rates and a 10% decline in long rates (due to a successfully-executed twist). On the basis of further assumptions, he then calculates what costs and benefits would have been, given the assumed 10% twist in the yield curve. A different assumption about the size of the twist would have resulted in different (hypothetical) estimates of the absolute costs and benefits.

Although Ross usefully emphasizes the point that evaluation of a policy intended to twist the rate structure must take into account domestic as well as external impacts, some of his quantitative calculations regarding the relative size of costs and benefits are open to doubt. His assertions about the interest-elasticity of inventory investment need further substantiation. On the international side, there are serious problems with his estimates of the balance of payments benefits. The nature and extent of the interest-sensitivity of short-term capital movement in the U.S. balance of payments is a subject currently undergoing extensive discussion within the economics profession. Some analysts would argue that Stein, and thus Ross, underestimate the balance of payments impact of a given change in U.S. short-term rates. Almost all analysts, regardless of their hunches about the interest-sensitivity of short-term capital movements, would agree that Stein's research procedures were exploratory and that much more work is needed to develop more accurate methods of estimating this impact. In an effort to help fill this need, the Federal Reserve System is currently engaged in research on the relationships between domestic financial conditions and international capital movements.

* * *

[1] The article appeared in the April 1966 issue of the *Journal of Political Economy*.

[2] See, for example, Franco Modigliani and Richard Sutch, "Innovations in Interest Rate Policy," *American Economic Review, Papers and Proceedings*, LVI (May 1966).

[3] Ross does not bring this fact out himself, but his criticisms are inapplicable unless the rate structure was significantly changed *from what* (given the cyclical factors in the economy and in government policy) *it would have been in any case*. As Modigliani and Sutch have pointed out, the fact that the spread between short and long rates narrowed greatly in the period from 1961 to 1965 is not sufficient evidence to prove that Operation Twist was responsible for this decline in the spread.

[4] Jerome L. Stein, "International Short-Term Capital Movements," *American Economic Review*, LV (March 1965).

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COMMENT BY HON. PAUL H. TODD, JR.

I appreciate the thoughtfulness of the response, and will look forward to receiving the results of current research being undertaken by the Federal Reserve System to establish more definitely the relationships between domestic financial conditions and international capital movements. I am impressed, however, that the response does not make a case for suggesting Operation Twist has a position as a policy tool for ameliorating the balance of payments difficulties the United States has experienced during recent years.

(Telegram from American Bankers Association criticizing position of Independent Bankers Association in support of measures to end rate war (see also IBA telegram, p. 613).)

JUNE 22, 1966.

Mr. PAT DUBOIS, *President*,
Mr. REED ALBIG, *Chairman, Federal Legislative Committee,*
The Independent Bankers Association of America,
Sauk Centre, Minn.:

Urge I.B.A. leaders to reconsider endorsement of 4½ percent certificate of deposit ceiling presented in your telegram on June 16 to Chairman of House Banking and Currency Committee. Rigidity of congressionally dictated ceiling at any rate undesirable but 4½ percent level offers imminent dangers to the main street banks which constitute your membership and bulk of A.B.A. membership. Your endorsement opens door to fixed statutory rate for banks without assurance of similar ceiling for savings and loan associations. We are convinced ability of small banks to attract and retain deposits vital to their communities could be greatly impaired by establishment of 4½ percent ceiling. Savings and loan associations mounting intensive drive to subject commercial banks to straightjacket of congressional controls. This is time for all commercial banking associations to stand together. A.B.A. had pledged all-out effort to protect banks of nation. Hope you will join with us in defending both the public interest and banking's interest.

CHARLS E. WALKER.

(Reply of Independent Bankers Association to American Bankers Association criticism.)

Mr. CHARLS E. WALKER,
Executive Vice President, American Bankers Association,
New York, N.Y.:

We have received your telegram, simultaneously publicized by your Washington office, criticizing the Independent Bankers Association's alleged endorsement of a four and one-half percent ceiling on commercial bank certificates of deposit. Its contents would indicate your failure to understand in depth the thrust of our June 16 telegram to the House Banking and Currency Committee members and the implications of an interest rate war. The pertinent portion of our June 16 telegram, dispatched after the committee voted to favor the five percent ceiling on consumer type CDs, said:

"We recognize that the thrust of this bill arises from concern for restraining a potential war between the mutual thrift associations and the commercial banks. This possible rate competition contains the elements of damage to both and is clearly not in the public interest. Likewise we recognize the potential for interest rate competition within the banking industry, as well as with the thrift institutions. However, we are opposed to the imposition of restraints on the commercial banks without comparable and appropriate restraints on the thrift institutions, which action we believe is equitable and fair. We are mindful of the experiences of the banking industry with former increases in the maximum permissible rates, where the permissible rate has rapidly become the floor as well as the ceiling. In view of this we do not believe a five percent rate will accomplish relief in the rate competition between the thrift institutions and the commercial banks. For such purpose it is our belief that the ceiling should not exceed four and one-half percent."

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We have reaffirmed our position before the House Banking and Currency Committee today following testimony by representatives of the savings and loan industry. Copy of testimony follows under separate cover. Immediately thereafter the committee adopted a resolution addressed to the Federal Reserve Board, urging it to act within thirty days to forestall threatened rate war. We hope this initiates action to resolve complex problems involved.

We urge you to join us in an all out effort to keep the record straight, in banking's interest and in the public interest.

Best regards.

PAT DUBOIS,
President, Independent Bankers Association of America.

(Resolution approved June 23 by Committee on Banking and Currency expressing sense of the committee that the Federal Reserve Board act within 30 days to end excessive interest rate competition.)

RESOLUTION

Whereas, the Federal Reserve Board has authorized interest rate increases on certificates of deposit and other time deposits, and;

Whereas, subsequent to this action large sums of money have been invested in these forms of deposits in commercial banks, and;

Whereas, other financial institutions—notably those for the encouragement of thrift—whose investments are in long-term investments have lost deposits and fear further losses which vitally affect the housing industry, and;

Whereas, this excessive interest rate competition and the threat of more such competition has caused considerable concern to Congress, to financial institutions and the public, and;

Whereas, the Federal Reserve Board was created and empowered to advise and guide American monetary policy, and;

Whereas, the Federal Reserve Board now has the power to put to an end this excessive interest rate competition between institutions;

Now, Therefore:

Be it resolved by the Committee on Banking and Currency of the United States House of Representatives, That it is the sense of this Committee that the Federal Reserve Board should act within thirty days to put to an end this excessive interest rate competition and to forestall the threat of such further competition.

(Federal Reserve Board June 27 announcement of results of survey of time and savings deposits at member banks.)

[Federal Reserve press release, June 27, 1966]

The Board of Governors of the Federal Reserve System made public today the results of the System's recent survey of time and savings deposits at its 6,200 member banks.

Information provided by the member banks covered rates and other terms offered to individuals, partnerships and corporations on various types of time and savings deposits, together with the dollar amounts of each type of deposit outstanding, for selected dates in December, March, and May.

The purpose of the survey, conducted simultaneously with a like survey by the Federal Deposit Insurance Corporation of all nonmember insured banks, was to provide up-to-date information on savings flows and rates. The major findings of the survey are summarized in this release and accompanying tables.

As in former periods of heavy reliance on monetary restraint to curb inflationary pressures, the supply of funds in credit markets has tended to fall short of credit demands, and competition for the available supply has intensified. As a result, yields on marketable securities traded in the money and capital markets have increased sharply, and savings institutions, under pressure to retain funds in the face of increasingly attractive market rates, have raised the rates of interest offered on various types of savings instruments, such as bank time and savings deposits and savings and loan shares.

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Reflecting these shifting competitive forces in the savings market and the restructuring of rates and yields which have been emerging, the course of saving flows has changed substantially. Inflows into all major types of savings institutions have slackened markedly since the turn of the year, while the direct flow of savings into security markets has increased. At member banks, for example, total time and savings deposits increased 5 percent in the first five months of the year, down from a 7½ percent increase in the same period of 1965. In contrast, investment by individuals in marketable securities rose sharply, and is estimated to have been four times as large in the first quarter of this year as in the first quarter of 1965.

Most of the reduction in member bank time and savings deposit growth rate is attributable to the absolute decline in passbook savings deposits, for which ceiling rates were not changed at the time of the revision in Regulation Q last December. Passbook savings deposits—which by regulation can be held only by individuals and certain nonprofit organizations—account for about two-thirds of the total time and savings deposits of individuals, partnerships and corporations in member banks. The other one-third is about evenly divided between "consumer-type" time deposits (which include savings certificates, savings bonds, other nonnegotiable certificates, and negotiable certificates in denominations under $100,000) and other time deposits of the type held mainly by businesses and other large investors, such as negotiable CD's in denominations of $100,000 or more and time deposits open account. Thus far this year, "business-type" time deposits, particularly large denomination CD's, have risen less rapidly than in 1965, but consumer-type time deposits have expanded sharply.

The decline in passbook savings deposits at member banks amounted to $1.2 billion between December 3, 1965 and May 11, 1966, as Table 1 shows, and it occurred despite a rise in the number of banks paying the maximum rate of 4 percent. At the time of the Regulation Q action, less than half of all member banks were paying the maximum rate; by May the proportion had risen to almost three-fifths of the total, with banks paying the maximum accounting for 87 percent of all savings deposits outstanding.

While the trend toward use of the ceiling rate did not prevent attrition in passbook savings, banks were more successful in attracting funds through issuance of other instruments of the type designated here as consumer-type time deposits. Such deposits rose by $5.3 billion, or 40 percent, between December and May. The bulk of the rise was accounted for by savings certificates and other nonnegotiable certificates of deposit, which together increased by $4.2 billion over the five-month period. As of May, over half of all member banks offered savings certificates, and about one-fourth issued nonnegotiable CD's. About one-fourth also issued small negotiable CD's, i.e., certificates of under $100,000 (an appreciable proportion of these are issued to businesses), and these CD's increased by $0.7 billion over the period. The sharpest rise, proportionately, was in the instrument generally called savings bonds, but these are still of relatively small importance in the total picture. Only about 3 percent of all member banks offer these bonds, and the amount outstanding in May represented less than 5 percent of all consumer-type time deposits.

Many factors contributed to the rise in consumer-type time deposits, including the attractive features of the instruments offered and aggressive promotion by banks, but undoubtedly the most important stimulus was the higher rates that could be paid on these instruments after last December. Between December and May, over half of the banks issuing these deposits raised rates on each type of instrument. Most of the rate increases occurred soon after the ceilings were raised in December; only half as many banks raised rates between March 2 and May 11 as had done so between December 3 and March 2 (Table 2). In the earlier period, the new rates tended to be raised to 4½ percent; in the latter period, the increases, while smaller in number, were more often to rates above 4½ percent, reflecting the continuing rise in competitive market rates of interest.

While many member banks took advantage of the enchanced competitive flexibility available after early December, few banks have gone all the way to the maximum rate permissible on consumer-type time deposits. As of May 11, the vast majority of member banks were paying maximum rates of 4½ percent or less on any of these deposits, and rates reported in excess of 5 percent were infrequent (Table 3). This is in contrast with changes in the rate structure on business-type time deposits. By mid-May, over half of the banks issuing large denomination negotiable CD's were paying over 4½ percent, and these

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banks accounted for 98 percent of these instruments outstanding. More recently, rates on large negotiable CD's have risen further, with rates of 5½ percent commonly being paid on short maturities.

On consumer-type deposits, the percentage of issuing banks paying rates above 4½ percent was generally higher for large banks than for smaller ones, reflecting in large part the more interest-sensitive environment in which larger banks operate as well as the strong business demands for funds that have tended to focus on large city banks. Thus, the percentage of the total amount of each instrument outstanding at rates above 4½ percent tends to be considerably larger than the percentage of the total number of banks paying such rates.

Since some banks issue more than one form of consumer-type time deposit, a better picture of the rate structure for this class of deposits as a whole is obtained by classifying banks according to the maximum rate they offer on any one of the four instruments designated here as consumer-type time deposits. This is done in Table 4, which shows that only 191 member banks, or about 8 per cent of all member banks issuing consumer-type time instruments, were paying rates above 5 per cent on any of these deposits on May 11. Moreover, the instrument on which the largest number of banks—103—was paying over 5 per cent was the small negotiable CD, an instrument often issued to business concerns as well as individuals.

The total volume of deposits of the types on which rates above 5 per cent were offered was $3.5 billion, or nearly one-fifth of all consumer-type time deposits outstanding. The number of banks and the volume of deposits reporting maximum rates above 4½ through 5 per cent was larger—18 per cent of the banks and 27 per cent of the consumer-type deposit total.

Of the banks paying over 5 per cent on any consumer-type deposit, nearly half were small banks, with total deposits under $50 million. If the comparison is broadened to include banks paying above 4½ per cent, two-thirds of those were small banks. But in relation to the number of banks in each size class, high rates were much more commonly offered by large than small banks. Thus, only about 10 per cent of the banks with deposits under $10 million were offering rates above 4½ per cent, compared with 90 per cent of the banks with deposits over $500 million. In terms of proportions of deposits, also, most of the "high-rate" consumer-type deposits were at large banks. Of the $8.6 billion of deposits on which rates over 4½ per cent were being offered, almost two-thirds were at banks with total deposits of $500 million or more.

As indicated in the lower part of Table 4, high-rate deposits were concentrated geographically. Banks in the New York and San Francisco Districts, which held about one-fourth of all consumer-type time deposits, accounted for about three-fourths of the deposits on which rates above 5 per cent were offered. Deposits on which the top rates offered were above 4½ per cent but not over 5 per cent were more broadly distributed, both by size of bank and by Federal Reserve District. The largest numbers of banks offering rates in the 4½–5 per cent bracket were in the Kansas City and Dallas Districts, both areas where smaller banks predominate and where time certificates have been used by small savers for many years.

The response of consumer-type savings flows to rate changes has not been uniform, by size of bank or geographically. In general, it would appear that smaller banks raising deposit rates have been more successful in attracting and retaining funds than have been larger banks (Table 5). Smaller banks, for example, continued to gain savings deposits over the December–May period and were generally able to attract funds into consumer-type time deposits at relatively moderate rates. The largest banks, in contrast, had substantial offsetting deposit flows, with passbook savings declining while consumer-type time deposits rose sharply. This was particularly true at banks offering more than 4½ per cent on consumer-type time deposits. The result was that the total of savings plus consumer time deposits at large "high-rate" banks grew much less rapidly over the period than did the total of these deposits at smaller banks offering comparable time deposit rates.

It is clear, then, that rate alone was by no means the only determinant of a bank's success in retaining or attracting consumer-type funds in the aggregate. Other factors influencing deposit experience included the extent of competition from other depositary institutions and the money market, the aggressiveness of bank promotion, and geographic location. The pattern of decline in passbook savings and increases in consumer-type time deposits prevailed in only six of the twelve Federal Reserve Districts. Shifts in deposit structure were most marked

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in the San Francisco District, but also were sizable in the New York, Chicago, Kansas City and Dallas Districts. In each of these, the largest shifts occurred among banks offering high rates on consumer-type time deposits. And in the Districts where large deposit shifts occurred, gains in the total flow of savings and time deposits tended to be lower than in other Federal Reserve Districts. The smallest gain in total was recorded in the San Francisco District, which had both the largest rise in consumer-type time deposits and the largest decline in passbook savings. The largest gain was in the Philadelphia District, where both passbook savings and consumer-type time deposits increased.

Within the over-all rise of $4.1 billion, or 4.7 per cent, in the total of passbook and consumer-type time deposits, there was also wide variation in deposit experience among individual member banks. As shown in Table 6, 754 banks experienced net attrition in the total. In most cases, the declines were less than 5 per cent, but some banks lost over 15 per cent of these deposits, including a few banks paying high rates of interest and of relatively large size. The table also shows that growth rates of banks gaining deposits varied widely, with nearly 500 banks showing increases in excess of 25 percent. About one-fifth of the banks showing such large increases paid no more than 4 per cent on any type of consumer deposits, although the more common tendency was for higher growth rates to be associated with payment of higher rates on time deposits. Thus, half of the banks paying over 5 per cent had deposit gains of more than 10 per cent, whereas only one-sixth of the banks paying 4 percent or less experienced such deposit rises.

Business-type time deposits of individuals, partnerships, and corporations, while rising less in early 1966 than in early 1965, grew faster than consumer-type deposits—8 per cent as compared with 5. This was also true among all size-groups of banks, as shown in Table 7. Thus, even after inclusion of business-type time deposits, smaller banks show a much sharper rate of growth over the December–May period in total time and savings deposits of individuals, partnerships and corporations than do large banks.

There was considerable variation in the behavior of business-type time deposits among Federal Reserve Districts. The two Districts with the lowest rates of growth on consumer-type deposits, namely, Boston and San Francisco, had the most rapid increases in business-type deposits, whereas in two Districts where consumer-type deposits showed relatively rapid growth rates, business-type deposits showed either little change or declines. These variations in deposit experience tended to narrow geographic differences in the growth rates of total time and saving deposits of individuals, partnerships and corporations.

Information was also collected on the survey relating to the minimum amount of deposit and the shortest maturity on which the maximum rate was offered for consumer-type time deposits. As is shown in Table 8, relatively few of the banks issuing consumer-type time deposits were limiting their highest rates to large denomination instruments as of May 11. Thus, for savings certificates—which are issued by just over one-half of all members—only one-eighth of the issuing banks stipulated a minimum denomination in excess of $1,000 to obtain the maximum rate, and two-fifths offered to pay that rate on denominations of $100 or less. Minimum denomination requirements were somewhat higher for nonnegotiable and small negotiable CD's. For savings bonds, however, most of the comparatively few issuing banks offered to pay the maximum rate on denominations of $100 or less.

Most banks will pay their top rate on consumer-type time deposits on maturities of a year or less. A sizable proportion—ranging from one-fifth in the case of savings certificates to over one-quarter for small negotiable CD's—offered the maximum rate with maturities of 3 months or less, although these are predominantly at 3 months. In the case of savings bonds, however, over one-third of the issuing banks have a minimum maturity longer than a year—five years in most cases. There is considerable diversity among both large and small banks with respect to the minima they establish, although smaller banks show somewhat more preference for longer maturities than large banks.

An analysis of changes in maturity and denomination on the various instruments over the entire period since December indicates that most banks changed neither their minimum maturity nor their minimum denomination of deposit on which the maximum rate is paid. Of those banks that changed maturity, considerably more lengthened than shortened it, and more banks raised their minimum denomination than reduced it. Moreover, a large proportion of the banks that lengthened maturity also raised their minimum denomination.

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TABLE 1.—*Types of time and savings deposits of individuals, partnerships, and corporations held by member banks, Dec. 3, 1965; Mar. 2, and May 11, 1966*

Type of deposit	Number of banks			Number on May 11 as percent of all member banks	Amount of deposits (in millions of dollars)		
	Dec. 3, 1965	Mar. 2, 1966	May 11, 1966		Dec. 3, 1965	Mar. 2, 1966	May 11, 1966
Total					105,372	108,348	110,944
Savings deposits	5,870	5,884	5,888	95	74,089	74,524	72,871
Consumer-type time deposits					13,090	15,098	18,384
Savings certificates	3,214	3,296	3,366	54	6,790	7,726	9,487
Savings bonds	111	147	162	3	402	675	856
Other nonnegotiable CD's	1,415	1,438	1,466	24	3,359	3,843	4,844
Negotiable CD's, under $100,000	1,521	1,528	1,549	25	2,539	2,854	3,197
Other time deposits					18,198	18,726	19,689
Negotiable CD's, $100,000 and over	600	623	632	10	13,141	13,235	13,815
Time deposits, open account:							
Christmas savings and other special funds	3,708	4,037	4,067	66	3,285	3,517	3,655
All other	875	882	889	14	1,767	1,974	2,219

Type of deposit	Change in amount (in millions of dollars)			Percentage change in amount		
	Dec. 3 to Mar. 2	Mar 2 to May 11	Dec. 3 to May 11	Dec. 3 to Mar. 2	Mar. 2 to May 11	Dec. 3 to May 11
Total	2,978	2,596	5,574	3	2	5
Savings deposits	435	−1,653	−1,218	1	−2	−2
Consumer-type time deposits	2,009	3,286	5,295	15	22	40
Savings certificates	936	1,761	2,697	14	23	40
Savings bonds	274	181	455	68	27	113
Other nonnegotiable CD's	484	1,001	1,485	14	26	44
Negotiable CD's, under $100,000	315	343	658	12	12	26
Other time deposits	534	963	1,497	3	5	8
Negotiable CD's, $100,000 and over	95	580	675	1	4	5
Time deposits, open account:						
Christmas savings and other special funds	232	138	370	7	4	11
All other	207	245	452	12	12	26

NOTE.—Dollar amounts may not add to totals because of rounding.

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TABLE 2.—*Banks increasing maximum rate paid on time and savings deposits between Dec. 3, 1965, and May 11, 1966*

Type of deposit	Banks issuing instruments	No change in rate [1]	Raising rate— Dec. 3 to May 11	Raising rate— Mar. 2 to May 11	Raising rate— Dec. 3 to Mar. 2
	Number of banks				
Savings deposits	5,888	4,853	1,035	192	843
Consumer-type time deposits:					
Savings certificates	3,366	1,475	1,891	619	1,272
Savings bonds	162	77	85	28	57
Other nonnegotiable certificates	1,466	639	827	285	542
Negotiable certificates, under $100,000	1,549	603	946	364	582
Other time deposits:					
Negotiable certificates, $100,000 and over	632	134	498	269	229
Time deposits, open account [2]	889	520	369	173	196
	Number raising rate as percentage of all banks in each group				
Savings deposits	100	83	17	3	14
Consumer-type time deposits:					
Savings certificates	100	44	56	18	38
Savings bonds	100	48	52	17	35
Other nonnegotiable certificates	100	44	56	19	37
Negotiable certificates, under $100,000	100	39	61	23	38
Other time deposits:					
Negotiable certificates, $100,000 and over	100	21	79	43	36
Time deposits, open account [2]	100	58	42	20	22

[1] Includes a small number of banks that decreased the rate paid.
[2] Excludes banks that had only Christmas club funds or other special types of time deposits, open account.

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TABLE 3-A.—*Maximum rates paid by member banks on time deposits and amounts of deposits held, by size of bank, May 11, 1966*

Type of deposit and size of bank (total deposits, in millions of dollars)	Banks issuing instruments	Maximum rate paid (percent)			Total issued	Maximum rate paid (percent)		
		4.50 or less	4.51 to 5.00	Over 5.00		4.50 or less	4.51 to 5.00	Over 5.00
	Number	*Number*	*Number*	*Number*	*Millions*	*Millions*	*Millions*	*Millions*
Consumer-type time deposits:								
Savings certificates, total	3,366	2,958	356	52	$9,487	$6,140	$2,780	$567
Under 10	2,026	1,852	150	24	1,886	1,743	119	25
10 to 100	1,146	993	133	20	3,708	3,121	490	97
100 and over	194	113	73	8	3,893	1,275	2,171	446
Savings bonds, total	162	128	26	8	856	371	262	223
Under 10	49	40	9		18	11	7	
10 to 100	75	57	12	6	99	46	10	43
100 and over	38	31	5	2	738	313	245	180
Other nonnegotiable CD's, total	1,466	1,207	202	57	4,844	1,959	772	2,113
Under 10	746	661	71	14	507	445	51	12
10 to 100	579	473	91	15	1,306	968	264	74
100 and over	141	73	40	28	3,030	545	457	2,028
Negotiable CD's, under $100,000	1,549	1,116	330	103	3,197	1,363	1,204	630
Under 10	689	569	101	19	434	361	56	17
10 to 100	625	466	130	29	1,039	751	225	62
100 and over	235	81	99	55	1,724	252	922	550
Other time deposits:								
Negotiable CD's, $100,000 and over	632	285	167	180	13,815	291	840	12,684
Under 10	73	50	17	6	17	10	4	3
10 to 100	309	179	86	44	353	111	98	145
100 and over	250	56	64	130	13,444	170	738	12,538
Time deposits, open account, total [1]	889	757	80	52	2,219	343	352	1,524
Under 10	325	315	10		53	47	6	
10 to 100	406	360	34	12	196	146	42	9
100 and over	158	82	36	40	1,970	151	304	1,516

[1] Excludes Christmas savings and other special funds.

NOTE.—Dollar amounts may not add to totals because of rounding.

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TABLE 3-B.—*Maximum rates paid by member banks on time deposits and amounts of deposits held, by size of bank, May 11, 1966 (percentage distribution within each group)*

Type of deposit and size of bank (total deposits, in millions of dollars)	Banks issuing instruments	Maximum rate paid (percent)			Total issued	Maximum rate paid (percent)		
		4.50 or less	4.51 to 5.00	Over 5.00		4.50 or less	4.51 to 5.00	Over 5.00
Consumer-type time deposits:		(*Number*)	(*Number*)	(*Number*)		(*Amount*)	(*Amount*)	(*Amount*)
Savings certificates	100	88	11	1	100	65	29	6
Under 10	100	92	7	1	100	93	6	1
10 to 100	100	87	11	2	100	84	13	3
100 and over	100	58	38	4	100	33	56	11
Savings bonds	100	79	16	5	100	43	31	26
Under 10	100	82	18		100	61	39	
10 to 100	100	76	16	8	100	47	10	43
100 and over	100	82	13	5	100	43	33	24
Other nonnegotiable CD's	100	82	14	4	100	40	16	44
Under 10	100	89	9	2	100	88	10	2
10 to 100	100	82	16	2	100	74	20	6
100 and over	100	52	28	20	100	18	15	67
Negotiable CD's, under $100,000	100	72	21	7	100	43	38	19
Under 10	100	82	15	3	100	83	13	4
10 to 100	100	74	21	5	100	72	22	6
100 and over	100	35	42	23	100	15	53	32
Other time deposits:								
Negotiable CD's, $100,000 and over	100	45	26	29	100	2	6	92
Under 10	100	69	23	8	100	59	23	18
10 to 100	100	58	28	14	100	31	28	41
100 and over	100	22	26	52	100	1	6	93
Time deposits, open account, all other: [1]	100	85	9	6	100	15	16	69
Under 10	100	97	3		100	89	11	
10 to 100	100	89	8	3	100	74	21	5
100 and over	100	52	23	25	100	8	15	77

Excludes Christmas savings and other special funds.

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TABLE 4.—*Consumer-type time deposits held by member banks on May 11, 1966, by maximum rate paid and size of bank*[1]

Size of bank (total deposits in millions of dollars) and Federal Reserve districts	Total	Maximum rate paid (percent)				Total	Maximum rate paid (percent)			
		4.00 or less	4.01 to 4.50	4.51 to 5.00	Over 5.00		4.00 or less	4.01 to 4.50	4.51 to 5.00	Over 5.00
	Number	*Number*	*Number*	*Number*	*Number*	*Millions*	*Millions*	*Millions*	*Millions*	*Millions*
All banks	5,618	1,899	2,786	742	191	$18,384	$2,096	$7,734	$5,620	$3,534
Under 10	3,254	1,305	1,596	298	55	2,847	824	1,737	233	54
10 to 50	1,775	518	970	253	34	4,560	839	2,991	625	106
50 to 100	251	39	126	62	24	1,592	109	948	364	170
100 to 500	258	36	89	95	38	3,024	276	1,277	1,078	394
500 and over	80	1	5	34	40	6,361	49	784	2,718	2,809
Federal Reserve district:										
Boston	170	54	51	51	14	157	10	38	63	46
New York	320	112	110	72	26	1,943	52	222	888	781
Philadelphia	344	133	184	21	6	1,153	157	668	277	51
Cleveland	450	273	135	37	5	1,172	339	500	254	79
Richmond	363	146	181	30	6	824	103	440	190	91
Atlanta	497	165	246	77	9	1,362	210	599	456	97
Chicago	964	384	499	67	14	3,528	609	1,770	892	257
St. Louis	447	135	270	38	4	1,367	229	748	352	38
Minneapolis	493	96	376	18	3	1,806	205	1,522	66	13
Kansas City	774	192	437	113	32	1,145	89	695	235	126
Dallas	582	193	249	123	17	810	81	321	330	78
San Francisco	214	16	48	95	55	3,085	15	208	1,002	1,809

[1] Consumer-type time deposits include savings certificates, savings bonds, other nonnegotiable certificates, and negotiable certificates in denominations of less than $100,000. Excludes banks that had no deposits of these types.

NOTE.—Dollar mounts may not add to totals because of rounding.

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TABLE 5.—*Change in savings deposits and in consumer-type time deposits from Dec. 8, 1965, to May 11, 1966, at various maximum rates paid on consumer-type time deposits, by size of bank, Federal Reserve district, and rate paid on savings deposits* [1]

[Amounts in millions of dollars]

Size of bank, Federal Reserve district, and maximum rate on savings deposits	All member banks				Maximum rate paid on any consumer-type time deposit on May 11, 1966															
					4.00 or less				4.01 to 4.50				4.51 to 5.00				Over 5.00			
	Total		Amount		Total		Amount		Total		Amount		Total		Amount		Total		Amount	
	Amount	Percent	Savings	Consumer type time	Amount	Percent	Savings	Consumer type time	Amount	Percent	Savings	Consumer type time	Amount	Percent	Savings	Consumer type time	Amount	Percent	Savings	Consumer type time
All member banks	4,078	4.7	−1,217	5,293	509	4.0	491	18	1,270	5.8	155	1,115	1,112	4.8	−429	1,541	1,186	4.1	−1,434	2,620
Size of bank (total deposits, in millions of dollars):																				
Under 10	598	8.3	178	420	169	5.3	118	51	301	8.8	41	259	88	15.3	14	73	41	47.1	4	36
10 to 50	1,029	6.2	298	731	201	3.8	191	10	532	6.1	72	460	203	9.1	4	198	93	29.8	31	63
50 to 100	374	5.2	76	298	36	2.5	42	−6	162	4.8	34	129	100	5.7	11	89	76	13.1	−10	86
100 to 500	809	4.3	48	761	98	3.5	135	−38	223	3.9	20	203	355	4.9	(2)	356	133	4.1	−106	239
500 and over	1,268	3.4	−1,816	3,084	6	5.3	6	(2)	53	6.7	−11	64	366	3.2	−458	824	843	3.4	−1,353	2,196
Federal Reserve district:																				
Boston	91	3.6	53	38	20	4.3	20	(2)	22	5.4	20	2	55	10.7	35	19	−5	−.4	−23	18
New York	656	4.3	−284	940	31	2.0	34	−2	77	3.1	55	23	157	3.8	−68	225	391	5.5	−304	695
Philadelphia	399	8.6	86	313	41	2.8	36	5	97	5.8	3	95	120	14.7	28	92	141	19.7	20	121
Cleveland	407	5.1	198	208	117	5.3	103	14	97	6.7	19	79	104	4.8	40	64	89	4.1	37	52
Richmond	330	7.6	99	231	56	4.8	58	−2	135	6.8	40	95	88	11.0	−1	89	51	12.9	2	49
Atlanta	362	7.4	133	229	63	4.1	76	−13	121	6.7	26	95	133	11.4	23	110	44	11.3	7	37
Chicago	674	4.1	−292	966	110	4.7	78	32	313	5.5	36	276	148	2.6	−203	350	104	3.7	−203	308
St. Louis	192	6.6	19	173	22	3.1	46	−24	125	8.8	6	119	14	4.0	−8	22	32	7.9	−25	56
Minneapolis	198	7.2	−21	219	6	1.7	−2	8	134	7.1	−14	148	35	15.0	−5	40	24	9.0	1	23
Kansas City	186	5.4	−81	267	16	3.7	13	3	88	5.9	−22	110	52	8.1	−10	62	29	3.2	−63	92
Dallas	131	4.0	−71	202	26	5.0	28	−2	44	4.0	−24	69	53	4.0	−67	119	8	2.3	−8	16
San Francisco	450	2.4	−1,056	1,506	1	1.2	1	(2)	17	3.0	12	5	153	2.8	−194	347	279	2.2	−875	1,154
Maximum rate paid on savings deposits, May 11, 1965:																				
3.00 or less	415	4.8	−71	485	95	3.0	8	87	235	5.6	−43	278	53	6.0	−10	63	31	7.3	−25	57
3.01 to 3.50	343	5.8	−25	367	43	2.7	27	16	241	6.7	−41	283	50	7.7	−6	56	8	8.9	−4	13
3.51 to 4.00	3,320	4.6	−1,121	4,441	371	4.7	457	−86	794	5.6	240	554	1,008	4.6	−414	1,422	1,147	4.0	−1,404	2,551

[1] Consumer-type time deposits include savings certificates, savings bonds, other nonnegotiable certificates, and negotiable certificates in denominations under $100,000.

[2] Less than $500,000.

NOTE.—Dollar amounts may not add to totals because of rounding.

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TABLE 6.—*Percentage change in total consumer-type time and savings deposits, Dec. 3, 1965, to May 11, 1966, by maximum rate paid on May 11, 1966, and by size of bank*[1]

[Number of banks]

Percentage change	All rates	Maximum rate paid (percent)			
		4.00 or less	4.01 to 4.50	4.51 to 5.00	Over 5.00
All banks[2]	6,032	2,314	2,785	743	190
Total increase	5,278	1,937	2,536	645	160
Increase of—					
Over 25.0	493	106	207	125	55
20.1 to 25.0	144	33	72	34	5
15.1 to 20.0	274	63	155	46	10
10.1 to 15.0	670	176	387	83	24
8.1 to 10.0	498	161	284	47	6
6.1 to 8.0	723	246	394	69	14
4.1 to 6.0	889	388	304	94	13
2.1 to 4.0	910	415	395	81	19
0.1 to 2.0	677	349	248	66	14
Total decrease	754	377	249	98	30
Decrease of—					
0.1 to 2.0	342	166	122	41	13
2.1 to 4.0	176	86	63	22	5
4.1 to 6.0	95	55	23	13	4
6.1 to 8.0	50	26	19	5	----------
8.1 to 10.0	25	10	8	5	2
10.1 to 15.0	39	20	9	8	2
Over 15.0	27	14	5	4	4
	All size groups	Size of bank (total deposits, in millions of dollars)			
		Under 10	10 to 100	100 to 500	500 and over
All banks[1]	6,032	3,565	2,122	265	80
Total increase	5,278	3,135	1,864	221	58
Increase of—					
Over 25.0	493	395	91	5	2
20.1 to 25.0	144	114	20	5	5
15.1 to 20.0	274	181	79	11	3
10.1 to 15.0	670	432	212	19	7
8.1 to 10.0	498	300	174	20	4
6.1 to 8.0	723	401	288	27	7
4.1 to 6.0	889	491	345	44	9
2.1 to 4.0	910	458	393	48	11
0.1 to 2.0	677	363	262	42	10
Total decrease	754	430	258	44	22
Decrease of—					
0.1 to 2.0	342	177	130	23	12
2.1 to 4.0	176	111	57	6	2
4.1 to 6.0	95	59	29	5	2
6.1 to 8.0	50	31	16	3	----------
8.1 to 10.0	25	12	7	4	2
10.1 to 15.0	39	19	17	1	2
Over 15.0	27	21	2	2	2

[1] Includes savings deposits, savings certificates, savings bonds, other nonnegotiable certificates and negotiable certificates of deposit in denominations under $100,000.
[2] Excludes banks with no consumer-type deposits on 1 or both dates.

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TABLE 7.—*Changes in time and savings deposits of individuals, partnerships, and corporations, by type, Dec. 3, 1965, to May 11, 1966*

[Dollar amounts in millions]

Size of bank and Federal Reserve district	Amount of change					Percentage change				
	Total	Business-type time deposits [1]	Consumer-type deposits			Total	Business-type time deposits [1]	Consumer-type deposits		
			Total	Savings	Consumer-type time [2]			Total	Savings	Consumer-type time [2]
All member banks	$5,574	$1,496	$4,078	−$1,217	$5,295	5	8	5	−2	40
Size of bank (total deposits, in millions of dollars):										
Under 10	645	47	598	178	420	9	34	8	4	17
10 to 50	1,183	154	1,029	298	731	7	28	6	2	19
50 to 100	463	89	374	76	298	6	23	5	1	23
100 to 500	1,122	313	809	48	761	5	13	4	(3)	34
500 and over	2,159	891	1,268	−1,816	3,084	4	6	3	−5	94
Federal Reserve district:										
Boston	214	123	91	53	38	6	16	4	2	32
New York	1,026	370	656	−284	940	4	4	4	−2	94
Philadelphia	445	46	399	86	313	8	7	9	2	37
Cleveland	601	195	407	198	208	6	12	5	3	22
Richmond	330		330	99	231	7		8	3	38
Atlanta	423	61	362	133	229	8	15	7	4	20
Chicago	850	176	674	−292	966	5	9	4	−2	38
St. Louis	180	−12	192	19	173	6	−4	7	1	15
Minneapolis	233	35	198	−21	219	8	13	7	−2	14
Kansas City	229	43	186	−81	267	6	14	5	−3	30
Dallas	219	88	131	−71	202	5	7	4	−3	33
San Francisco	829	379	450	−1,056	1,506	4	22	2	−6	95

[1] Includes negotiable CD's in denominations of $100,000 or more and time deposits, open account.

[2] Includes savings certificates, savings bonds, other nonnegotiable certificates, and negotiable certificates in denominations under $100,000.

[3] Less than 0.5 percent.

NOTE.—Dollar amounts may not add to totals because of rounding.

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TABLE 8.—*Minimum denomination and shortest maturity on which maximum rate was paid on May 11, 1966, by size of bank (percentage distribution of number of banks within bank size groups)*

Type of deposit and size of bank (total deposits, in millions of dollars)	All denominations	Minimum denomination: $100 and under	$101 to $1,000	$1,001 to $2,500	$2,501 to $5,000	$5,001 to $10,000	$10,001 to $25,000	Over $25,000
Savings certificates, total	100	41	47	4	4	2	1	1
Under 100	100	42	47	3	4	2	1	1
100 and over	100	30	35	21	6	1	3	4
Savings bonds, total	100	70	21	6	2	1	-------	-------
Under 100	100	70	21	6	2	1	-------	-------
100 and over	100	71	18	8	3	-------	-------	-------
Other nonnegotiable CD's, total	100	34	41	4	7	6	3	5
Under 100	100	36	43	4	7	5	2	3
100 and over	100	17	26	9	9	9	9	21
Negotiable CD's, under $100,000, total	100	31	38	5	8	8	5	5
Under 100	100	34	43	4	8	6	3	2
100 and over	100	15	16	4	12	18	15	20

Type of deposit and size of bank (total deposits, in millions of dollars)	All maturities	Minimum maturity: 3 months or less	4 to 6 months	7 to 12 months	Over 12 months
Savings certificates, total	100	21	27	49	3
Under 100	100	21	27	50	2
100 and over	100	25	37	30	8
Savings bonds, total	100	40	5	19	36
Under 100	100	38	6	19	37
100 and over	100	47	3	16	34
Other nonnegotiable CD's, total	100	24	29	44	3
Under 100	100	23	29	45	3
100 and over	100	29	38	31	2
Negotiable CD's, under $100,000, total	100	27	31	40	2
Under 100	100	27	29	42	2
100 and over	100	31	41	27	1

(Federal Reserve Board June 27 announcement of increase in required reserves against time deposits from 4 to 5 percent.)

[Federal Reserve press release, June 27, 1966]

The Board of Governors of the Federal Reserve System announced today two actions designed to moderate further growth of bank credit and deposits: an increase in reserve requirements against certificates and other forms of time deposits, and an extension of regulations regarding reserve requirements and interest on deposits to shorter-term promissory notes of banks.

Reserve requirements were increased from 4 per cent to 5 per cent against the amount of time deposits (other than savings deposits) in excess of $5 million at each member bank. The increase will become effective with the reserve computation periods beginning July 14, 1966, for Reserve city banks, and July 21, 1966, for all other member banks.

It is estimated that this action will increase required reserves by more than $400 million—approximately $350 million at Reserve city banks and $70 million at other member banks. All told, about 950 larger member banks throughout the country—primarily those issuing savings certificates and other certificates of deposit (CD's) in large volume—are expected to be affected by this increase in requirements. The action should exercise a tempering influence on bank issuance of time certificates of deposit. The measure will also serve to apply a moderate additional measure of restraint upon the expansion of banks' loanable funds and thus reinforce the operations of other instruments of monetary policy in containing inflationary pressures.

At the same time, the Board acted to bring shorter-term bank promissory notes and similar instruments under the regulations governing reserve requirements

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and payment of interest on deposits. This action would not apply to Federal funds transactions, interbank borrowings, transfers of assets with agreements to repurchase, or bank notes for capital purposes that have a maturity of more than two years and are subordinated to claims of depositors. The action will become effective September 1, 1966 and will apply to all promissory notes covered by the action that are issued on or after June 27, 1966, and are outstanding on or after the effective date. Promissory notes and other instruments of the type covered by the action have come into use only in the last few years and the volume outstanding at present is small. The purpose of the Board's action is to prevent future use of these instruments as a means of circumventing statutory and regulatory requirements applicable to bank deposits.

Attached are the texts of the amendments to the Supplement to the Board's Regulation D, Reserves of Member Banks, and to Regulation Q, Payment of Interest on Deposits, which implement this action.

TITLE 12. BANKS AND BANKING

CHAPTER II. FEDERAL RESERVE SYSTEM

SUBCHAPTER A. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. D]

PART 204. RESERVES OF MEMBER BANKS

Reserve percentages

1. Effective as to member banks in reserve cities at the opening of business on July 14, 1966, and as to all other member banks at the opening of business on July 21, 1966, § 204.5 [Supplement to Regulation D] is amended to read as follows:

§ 204.5 Supplement.

(*a*) *Reserve percentages.*—Pursuant to the provisions of section 19 of the Federal Reserve Act and § 204.2(a) and subject to paragraph (b) of this section, the Board of Governors of the Federal Reserve System hereby prescribes the following reserve balances which each member bank of the Federal Reserve System is required to maintain on deposit with the Federal Reserve bank of its district:

(1) If not in a reserve city—

(i) 4 per cent of its savings deposits, plus

(ii) 4 per cent of its other time deposits up to $5 million and 5 per cent of such deposits in excess of $5 million, plus

(iii) 12 per cent of its net demand deposits.

(2) If in a reserve city (except as to any bank located in such a city which is permitted by the Board of Governors of the Federal Reserve System, pursuant to § 204.2(a)(2), to maintain the reserves specified in subparagraph (1) of this paragraph)—

(i) 4 per cent of its savings deposits, plus

(ii) 4 per cent of its other time deposits up to $5 million and 5 per cent of such deposits in excess of $5 million, plus

(iii) 16½ percent of its net demand deposits.

(*b*) *Counting of currency and coin.*—The amount of a member bank's currency and coin shall be counted as reserves in determining compliance with the reserve requirements of paragraph (a) of this section.

2a. This amendment is issued pursuant to the authority granted to the Board of Governors by section 19 of the Federal Reserve Act to change reserve requirements to prevent injurious credit expansion or contraction (12 U.S.C. 462b). The only change is to increase the reserves that must be maintained against time deposits (other than savings deposits) in excess of $5 million from 4 per cent to 5 per cent.

b. There was no notice and public participation with respect to this amendment as such procedure would result in delay that would be contrary to the public interest and serve no useful purpose. (See § 262.1(e) of the Board's Rules of Procedure (12 CFR 262.1(e)).)

Dated at Washington, D.C., this 27th day of June, 1966.

By order of the Board of Governors.

MERRITT SHERMAN, *Secretary.*

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TITLE 12. BANKS AND BANKING

CHAPTER II. FEDERAL RESERVE SYSTEM

SUBCHAPTER A. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

[Reg. D and Reg. Q]

PART 204. RESERVES OF MEMBER BANKS
PART 217. PAYMENT OF INTEREST ON DEPOSITS

Certain promissory notes

1. Effective September 1, 1966, § 204.1 and § 217.1 are amended as follows:
(a) Paragraphs (f), (g), (h), and (i) of § 204.1 are redesignated as paragraphs (g), (h), (i), and (j), respectively.
(b) A new paragraph (f) is inserted as follows:

§ 204.1 Definitions.
§ 217.1 Definitions.

* * * * * * *

(f) *Deposits as including certain promissory notes.*—For the purposes of this part, the term "deposits" shall be deemed to include any promissory note, acknowledgment of advance, due bill, or similar instrument that is issued by a member bank principally as a means of obtaining funds to be used in its banking business, except any such instrument (1) that is issued to another bank, (2) that evidences an indebtedness arising from a transfer of assets that the bank is obligated to repurchase, or (3) that has an original maturity of more than two years and states expressly that it is subordinated to the claims of depositors. This paragraph shall not, however, affect the status, for purposes of this part, of any instrument issued before June 27, 1966.

2a. This amendment is issued under the Board's authority to prevent evasions of the purposes of section 19 of the Federal Reserve Act (12 U.S.C. 461). It is designed to bring within the coverage of Regulations D and Q promissory notes and similar instruments of the type that banks have developed in recent years as a means of obtaining funds for use in the ordinary course of their banking business.

b. Notices of proposed rule making with respect to this amendment were published in the Federal Register of January 26, 1966 (31 F.R. 1010) and of April 2, 1966 (31 F.R. 5320). The amendment was adopted by the Board after consideration of all relevant material, including responses received from interested persons pursuant to those notices.

Dated at Washington, D.C., this 27th day of June, 1966.

By order of the Board of Governors.

MERRITT SHERMAN, *Secretary.*

(Wall Street Journal article of June 28 on action of Federal Reserve Board increasing required reserves on time deposits from 4 to 5 percent.)

[From the Wall Street Journal, June 28, 1966]

TIME-DEPOSIT RESERVE REQUIREMENTS RAISED TO RESTRAIN ISSUANCE OF CD'S, BUT BOOST BY RESERVE BOARD TO 5 FROM 4 PERCENT IS TERMED TOO MILD FOR MUCH IMPACT

(By a Wall Street Journal staff reporter)

WASHINGTON.—The Federal Reserve Board sought to restrain banks' issuance of certificates of deposit by increasing the reserve requirements behind them; both commercial banks and Congressional critics said the move in itself was too mild to have much impact.

In a surprise action, the Reserve Board voted unanimously to set a 5% reserve requirement on time deposits—other than regular savings account deposits—in excess of $5 million at each member commercial bank. Since late 1962, banks have had to keep a reserve of 4%—that is, cash banks must set aside at district

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Reserve banks—behind all time deposits. Under current law, the board can set the requirement between 3% and 6%.

Also, the board adopted a simplified form of a previously proposed regulation to subject the proceeds of certain shorter-term promissory notes issued by banks to both reserve requirements and interest-rate ceilings.

The increase in backing certificates will take effect with the reserve computation periods beginning July 14 for Reserve city banks—generally banks in cities where there is a Federal Reserve district bank or branch—and July 21 for all other member banks. This is believed to be the first time the board has set different reserve requirements for different types of time deposits.

The move is intended to affect about 950 of the country's larger banks that issue certificates in large volume, the board said. Certificates of deposit are receipts for money deposited for a specified period of time. Those issued in large denominations to large customers by big banks are usually negotiable, so that the depositor may obtain cash in advance of maturity by selling the certificate to a money market dealer.

PATMAN DENOUNCES MOVE

The board's action was promptly denounced as inadequate by Rep. Patman (D., Texas), chairman of the House Banking Committee. "I look upon it as an invisible crumb from the rich man's table," he said.

Mr. Patman said his committee would renew its attempt to impose legislative curbs on bank time-deposit payments unless the Reserve Board took more stringent action within 30 days. He said the board should roll back the interest-rate ceiling on bank time deposits such as certificates of deposit to 4.5% from the current 5.5%.

There isn't any concensus on the 33-man House Banking panel on how to curb demand for high-paying certificates. But panel members are under snch strong pressure from the savings and loan industry for relief from bank competition that it's likely another attempt will be made to take legislative action. If nothing else, it's believed that the Banking panel might hold more hearings in a month or so to build pressure on the board to take further administrative steps to cool off demand for the certificates.

Lately, more banks have also been issuing "consumer-sized" certificates in amounts as small as $25, bringing complaints from the savings and loan industry that savers' funds are being drained away from S&Ls, reducing their ability to make home mortgage loans. With home building off sharply in recent months, Congressmen have been urging the board to crack down on the smaller certificates.

$400 MILLION IN ADDITIONAL RESERVES

In raising by one percentage point the reserves behind some $40 billion of time deposits, the board figures banks will have to set aside more than $400 million extra as reserves.

About $350 million more will be required of Reserve city banks and about $70 million more from other member banks. At last count June 15, member banks were keeping almost $22.1 billion behind all types of deposits, both time and demand, or checking deposits.

"The action," the board said, "should exercise a tempering influence on bank issuance of time certificates of deposit." It will also, the board stated, "serve to apply a moderate additional measure of restraint upon the expansion of banks' loanable funds and thus reinforce the operations of other instruments of monetary policy in containing inflationary pressures."

Officials of large CD-issuing banks around the country said they expected the increased reserve requirements to have only nominal effect on the amount and rates of certificates offered. Several bankers, however, said the Federal Reserve's action represented another move toward tightening credit and if followed by other measures the impact on the nation's credit supplies and economic activity would become broad.

COST TO BANK

A New York banker said he figures that as a result of setting aside somewhat more cash reserves at the district reserve bank it will henceforth cost his institution for a 5.5% CD another 0.38%, instead of 0.32% currently; in addition to paying the 5.5% in this instance to the investor, the bank figures it incurs the ad-

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ditional expense for leaving cash at the Federal Reserve where the funds cannot earn interest and for an insurance fee paid on the deposit to the Federal Deposit Insurance Corp.

"As a matter of expense, the added reserves will require only marginal added costs to the banks," the New York banker said. "So from this point of view, it's a pimple on an elephant's back. But the fact remains that the 'Fed' has given the tight-money screw another turn, and that could possibly lead to a further boost in interest rates" banks charge for loans.

In San Francisco, Lester H. Empey, senior vice president of Wells Fargo Bank, said that while his institution "had been expecting some type of restriction, we don't consider this raising of reserve requirement a radical change."

He noted that "its purpose is to restrict somewhat our CD activities in competition with other financial institutions," and added it "will only affect our very large corporate accounts."

A high official of Continental Illinois National Bank & Trust Co. of Chicago characterized the Federal Reserve Board's move as "a careful, cautious" response to Congressional suggestions. The official said the move probably wouldn't have a significant effect on banks issuing CD's. He noted that the economy is already in a period of tight money and "credit restraint."

He also doubted whether the move will eventually trigger an increase in the banking system's basic lending or "prime" rate, currently 5½%.

SAVINGS AND LOAN REACTION

In Los Angeles, several executives of savings and loan associations expressed reservations over how effective the Federal Reserve's move might prove in dampening the competition of the CD-issuing banks with S&Ls for investment funds.

Said Edward Johnson, president of Financial Federation, Inc., a savings and loan holding company: "Conceivably this could help steer additional funds into mortgage channels. It might cause some banks to be less aggressive in acquiring savings capital, which would help the S&L business in building its capital earmarked for mortgage lending. How effective it will be, I don't know."

Elwood Teague, chairman of United Financial Corp., another major Los Angeles savings and loan holding company, said he doubted if the "move will have any measurable effect on the flow of savings from S&Ls to banks." He said the action "obviously was a move to assure Congress that the 'Fed' does have the power to prevent further rate wars, but it's a rather token movement. It isn't going half far enough."

In the same vein Stephen Slipher, legislative director of the U.S. Savings and Loan League, in Washington, D.C., said that unless the Federal Reserve accompanies its "modest change" in reserve requirements with more significant action, it "will do little or nothing to restore competitive balance" between associations and banks. However, he said its action does "indicate that the Federal Reserve isn't going to be completely unresponsive" to the House Banking Committee's recent resolution calling on it to take some such action.

In New York, Leif H. Olsen, senior vice president and economist of First National City Bank, New York, agreed that the Federal Reserve's action is "relatively nominal." He said he doesn't expect the action to dampen sales of CD's or the yields paid on them by banks.

The Reserve Board's other action brings certain promissory notes under the reserve and interest rate regulations as of Sept. 1, covering those issued on or after yesterday. The volume of such instruments that have been outside the rules is still "small," the board said, explaining its aim is to prevent future use of them as a means of "circumventing statutory and regulatory requirements applicable to bank deposits." Generally, the change was made by redefining the word "deposits" to include such notes with maturities of two years or less.

The new definition includes such notes issued by a member bank "principally as a means of obtaining funds to be used in its banking business," but excludes those issued to another bank, that evidence indebtedness rising from a transfer of assets that the bank is obligated to repurchase, or that have an original maturity of more than two years and are expressly subordinated to depositors' claims.

SURVEY OF SAVINGS INSTITUTIONS

Apparently influencing the board against a sterner CD crackdown was its simultaneously released survey of the savings situation at its 6,200 member

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banks. The study, begun early last month, shows, the board said, that "inflows into all major types of savings institutions have slackened markedly since the turn of the year, while the direct flow of savings into security markets has increased."

Time and savings deposits at member banks rose 5% in the first five months of this year, compared with a 7.5% gain in the like period of last year. In contrast, the board said it estimated that investment by individuals in marketable securities was "four times as large in the first quarter of this year as in the first quarter of 1965."

Banks suffered a $1.2 billion decline in passbook savings deposits between last Dec. 3 and May 11, the report showed, but in the same span their consumer-type certificates and similar instruments gained $5.3 billion, or 40%. The bulk was in savings certificates and other nonnegotiable certificates, up by $4.2 billion.

While the board credited its December increase in the rates banks can pay to attract time deposits, it said the move by banks toward the new 5.5% ceiling has slowed. In December, the board raised to 5.5% from 4.5% the maximum rate banks may pay on time deposits, but left at 4% the ceiling on regular savings deposits, which in practice usually can be withdrawn at any time without prior notice.

Only half as many banks raised rates on consumer-type time deposits between March 2 and May 11 as between Dec. 3 and March 2, the board said. As of May 11, it added, the "vast majority" were paying top rates that didn't exceed 4.5% on any such deposits and said rates in excess of 5% were "infrequent."

Rate alone "was by no means the only determinant of a bank's success in retaining or attracting consumer-type funds," the board found. Smaller banks continued to gain savings deposits in the December–May period and were generally able to attract funds into consumer-type time deposits at "relatively moderate rates." But the larger banks had substantial offsetting declines in passbook savings, the board said. It concluded that other influences on deposit flows included the extensive competition from other institutions and the money market, the aggressiveness of bank promotion, and geographic location.

(Announcement by Federal Home Loan Bank Board in response to "minimal action taken by the Federal Reserve Board.")

[Federal Home Loan Bank Board release, June 28, 1966]

WASHINGTON, D.C.—The issuance by member savings institutions of six-months savings certificates of $1,000 minmums at an annual divdend rate of up to 5 percent has been authorized on a nationwide basis by the Federal Home Loan Bank Board, Chairman John E. Horne announced today.

"This modification of Board policy was made," Mr. Horne said, "following a two-day meeting between the Board and its staff and the Presidents of the twelve Federal Home Loan Banks. A further determining factor was the minimal action taken by the Federal Reserve Board with regard to increasing reserve requirements behind certificates of deposit.

"The Board is continuing its credit restrictions based on dividend practices.

"The action by the Board reflects its desire and that of its Bank Presidents to reduce the drain on available mortgage funds for housing caused by the widespread practice of commercial banks in paying 5 percent or more on consumer certificates of deposit, while deterring further escalation in competitive interest rates.

"The Board cautions associations that they should consider their ability to meet their reserve and other requirements in offering the higher rate on savings certificates.

"In the view of the Board, a more appropriate approach would be to (a) reduce the widespread availability of consumer certificates of deposit, (b) to grant the Federal Home Loan Bank Board standby control over dividend rates of savings and loan associations, and (c) to require coordinated setting of rates for deposits and savings accounts.

"Should these tools become available, the Board would review its current policy modification in the light of conditions that then exist."

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(Washington Star June 29 editorial cartoon indicating Federal Reserve Board's weakness and indecision to bring interest rate war to immediate halt.)

[From the Washington Star, June 29, 1966]

'Okay, fellows—break it up!"

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