Memo from Bill Martin - recommends removing reg Q ceilings - First clear notice of intent to raise rates

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October 6, 1965.

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Memorandum for The President.

Too much emphasis is being put on interest rates.

The real problem is to keep funds flowing freely and effectively to sustain healthy progress in the economy.

Whether interest rates move a bit higher--or a bit lower--is not of cardinal importance to the economy.

What is important is whether rates are allowed to respond to market forces so that an effective flow of funds is assured.

The trouble confronting us is that rate ceilings--governed by policy determinations--are proving obstacles to the flow of funds in accordance with natural forces.

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And the most immediate obstacle is the ceiling not on the rate that banks may charge borrowers but on the rate they may pay depositors to attract funds that the banks need in order to expand their loans.

Specifically, this is the way matters stand:

-- In vigorous competition to attract funds to meet increasing loan demands, banks have been offering higher and higher rates for certificates of deposit.

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-- But under ceilings imposed by the Federal Reserve's Regulation Q, going back to November in 1964, banks are forbidden to pay more than 4-1/2 per cent to obtain deposit funds.

-- Some of the leading financial-center banks are paying the top rate already, and cannot now go any higher to attract further funds.

-- Banks with lesser standing, especially those outside the chief financial centers, are being hard-pressed even to hold present deposits, much less to gain added deposits, since the ceiling puts them at a competitive disadvantage with financial-center banks of higher credit standing.

-- These impediments are being reflected in the credit distribution process in a way that is distinctly adverse to smaller borrowers.

This obstacle to the attraction of funds for lending could be overcome by lifting the 4-1/2 per cent maximum rate that banks presently may pay for deposits.

But two other things would logically be required:

1. A simultaneous increase in the 4 per cent discount rate that member banks presently must pay on their borrowings from the Federal Reserve, lest the widened disparity impel these banks to converge on the Federal Reserve as the cheapest possible source of funds.

2. A greater willingness to recognize that, if banks find it more costly to obtain the funds needed to expand

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their loan volume, they will either (a) charge more for new loans, to recoup their higher costs, or (b) show less interest in meeting new loan demand, since that would entail increased risk for a smaller net return.

The disadvantage of the course outlined would, quite obviously, be higher interest rates. But there would be these outweighing advantages:

-- Far from restricting the flow of funds to meet mounting loan demands, the higher rate structure would open up a freer, more effective flow of funds in response to the most economically justified borrowing demands. The position of smaller borrowers would clearly be improved.

-- With this freer, more effective flow of funds that are already available in the economy, economic growth would be made less dependent on a burgeoning stream of newly created money and--in consequence--made less vulnerable to dangers of inflationary developments that would end growth, and bring recession.

-- While these dangers can be debated--one is always confronted by the statistics that are not there--rising expectations, evidenced in financial markets and real investment, and price warnings suggest slightly higher interest rates would prove beneficial to sustaining and stretching out the expansion. And our present balance of payments picture suggests the further advantage of needed reinforcement of the voluntary program in the manner outlined.

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