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Statement of

William McChesney Martin, Jr., Chairman,

Board of Governors of the Federal Reserve System,

before the

Committee on Banking and Currency

of the

House of Representatives

June 8, 1966

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. 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 available 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 returns 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.

Short-run 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 per cent would give considerably greater flexibility than now exists.

Increased flexibility of this kind could be utilized more effectively if the proposed amendment permitted graduation 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 Vietnam 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 per cent 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 six 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 six 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 per cent ceiling on 3- to 4-month money in the market for large-denomination CD's. According to our latest CD maturity survey, over 80 per cent of the outstanding large negotiable CD's will mature in the next six months. Thus, with the present ceiling rate of 5½ per cent, a prohibition against issuing CD's of less than six months maturity might cause banks to lose a large portion of these deposits over the next six 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 six 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 home builders 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 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. 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 per cent 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 per cent, 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 per cent 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 per cent 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.