Liquidity in Our Expanding Economy*

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It is a pleasure to meet again with this distinguished group and discuss some of the common problems affecting the commercial banker and central banker. In talking to you a year ago I devoted my remarks to the urgent problem of our balance-of-payments deficit and the consequent international challenge which our monetary policy has had to meet. While that problem and challenge remain urgent —notwithstanding some good progress in the past six months—I'd like to concentrate today on domestic monetary matters. In particular, I should like to call attention to some questions raised by the state of liquidity inside and outside the banking system as our economy continues the expansion that began some three years ago. For on this "home ground" for the commercial and central banker I believe we are evolving important new experience of mutual interest. I hasten to add, however, that in focusing on domestic credit developments we cannot, these days, afford to ignore balance-of-payments implications; for these are clearly an inseparable part of the total economic picture, and they have played, and will certainly continue to play, a significant role in shaping the course of monetary policy.

As a starting point, it might be appropriate to sketch quickly the economic position and monetary policy posture of the past few years. Essentially, the Federal Reserve System has faced the task over this period of fostering sustainable domestic economic growth while strengthening and protecting the international position of the dollar. Toward the end of 1961, with economic recovery from a mild recession well under way, the System began to move gradually toward reducing the degree of monetary ease adopted during the recession. These moves continued as the domestic economy advanced further while the balance-of-payments deficit displayed disappointing stubbornness. By the middle of 1963 the further gains in our domestic economy made more feasible, and the deterioration in our balance of payments made imperative, a more overt move toward less ease—designed particularly to check the outflow of funds attracted by higher interest rates available abroad.

The increase in the discount rate last July, and the accompanying firming of the money market atmosphere, was immediately reflected in higher short-term interest rates, which in turn contributed importantly to the improvement in our balance of payments during the second half of last year. At the same time, the growth of bank credit has continued practically unabated, as monetary policy from the domestic standpoint has retained a distinctly accommodating posture—albeit a less openly stimulative one than earlier. As a result, the economy is about as liquid, and by some standards even more liquid, now than in the recessionary period of a few years ago when the Federal Reserve was aggressively pushing reserves into the financial stream. In dollar terms the economy's liquidity has scaled unprecedented heights.

During earlier postwar expansion periods, in contrast, the liquidity of the economy typically sustained a marked decline. Growth in money supply slowed down and increases in total liquid assets proceeded more moderately than the increases in total spending, while higher interest rates throughout the maturity range and for various types of debt registered the increased pressure of demand on loanable funds. Of course, in partial explanation of the contrasting experience in the current expansion, we have had along with the recent rise in economic activity a persistent margin of unemployed resources, and a welcome absence of general inflationary pressures. With unemployment rates hovering between 5 and 6 per cent of the labor

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force and broad price averages holding relatively steady, there has been no call for restrictive monetary policies of the kind that were appropriate in some earlier postwar years of business expansion.

Nevertheless, I think we must ask ourselves whether the growth in volume, and changes in form, of liquidity instruments characteristic of the past year or two will remain appropriate for our economy as it moves ahead. Apart from any balance-of-payments impact of our high liquidity, there is the cumulative effect on the domestic financial climate to be considered. This is of broad concern not only to the central banker, because of his necessary preoccupation with the totality of financial developments, but also of particular concern to the commercial banker because of the special role of bank demand deposit money in the economic adjustment process and the very striking role of bank time deposits in recent liquidity growth.

Before proceeding further to examine the recent record, it might be well to agree on what we mean by the term "liquidity" in the nonbank sectors of the economy. For any single individual or business, liquidity may be defined simply as holdings of cash and ready access to cash through sale of assets. In turn, ready access to cash may be thought of as assets that are marketable at little risk of loss of principal. Thus we have in mind here a number of types of assets, ranging from "money" in the usual narrow sense of currency plus bank demand deposits through a wide variety of "near-money" instruments, such as savings deposits and short-term Government securities. The liquidity of any of these short-term assets depends on the ability of financial markets to convert them into money in the narrow sense at little or no sacrifice. Needless to say, there are different degrees of liquidity or "nearness to money" depending on how readily and at what price this conversion can be accomplished.

Commercial banks and many other financial institutions share the ability to provide liquid assets in exchange for longer term or other less liquid claims on the private and public sectors of the economy. A good deal of the liquidity required by the economy is generated as banks and other financial intermediaries attract personal and corporate money savings or temporarily idle funds and give, in return, interest-earning deposits, shares, insurance policies, or comparable instruments. These intermediary financial institutions, in turn, assure their ability to meet liquid liabilities by keeping cash or near-money reserves the size and nature of which are determined by experience, custom, and official regulation. Among the intermediaries, however, commercial banks have the unique ability to create the most liquid kind of financial asset—demand deposit money—which, together with currency, is the only universal means of payment.

This little discourse on our monetary system is rather elementary fare for this group, but I assure you that I find it most useful to remind myself of these fundamentals before treading on the more slippery ground that I'd like to cover today. For when it comes to considering the role of particular types of institutions in this broad framework, and especially the changing position occupied by commercial banks in recent years—and the potential implications of such changes for monetary policy—it is quite desirable indeed to have these elementary points in mind.

Let me approach these considerations by noting, as you well know, that commercial banks have become increasingly aware in recent years of the desirability of acquiring savings and other time deposits to be channeled into higher yielding assets. For personal savings accounts, this tendency goes back through most of the postwar period, although there has been a notable acceleration in the last few years. As regards corporate and other time deposits, the period of rapid growth is more recent but the total increments have been even more spectacular. The ability of commercial banks to enlarge their role as financial intermediaries has been strikingly enhanced by the recent series of changes in Federal Reserve Regulation Q, particularly since the end of 1961, and by the emergence of negotiable time certificates of deposit as a major money market instrument. Raising the ceiling rates that commercial banks may pay on time deposits placed the banks in a position to compete for corporate and other funds seeking temporary investment. A large volume of funds that previously might have been invested mainly in Treasury bills or private money market instruments was thus retained in, or brought back to, the banking system.

I promise not to weigh you down with statistics, but I think a few numbers are needed here to nail down some of the general magnitudes involved. Thus the growth in commercial bank time deposits last year was over $14 billion, and this followed on the heels of a similarly large increase in 1962. Perhaps about a third of that two-year rise has taken the form of negotiable time certificates of deposit, issued mainly to corporations. By itself, of course, the liberalization of Regulation Q was merely permissive, with the active force provided by aggressive bank bidding for funds. However, the sharp burst of expansion in time deposits has not taken place, in any readily obvious manner, at the expense of growth in other near-money forms. Substantial growth has continued in mutual savings bank deposits and savings and loan shares, and there has been a continuing growth in holdings of Treasury bills, other short-term Government securities, and various types of commercial paper outside the banking system. For the most part, then, the enormous growth of commercial bank time deposits has come from new savings and transfers from demand balances of funds that either had been relatively idle or that were newly created through the familiar processes of bank credit and deposit expansion. Thus in the same two years that commercial bank time deposits rose by some $29 billion, or 35 per cent, the demand deposit component of money supply rose only about $5 billion, or roughly 4 per cent. Even currency in circulation —which one does not usually think of as a highly significant component of a financial mechanism as sophisticated as our own—expanded more quickly than bank demand deposits, rising about $3 billion or 10 per cent over the past two years.

The accelerated growth of near-money assets and relatively slower growth of money supply are not products merely of the past few years. These trends have been in process ever since the end of World War II, and particularly since the 1951 Treasury-Federal Reserve accord, when flexible monetary policy was re-established in this country. Once some of the excessive wartime liquidity was siphoned off in the immediate postwar years, an atmosphere re-emerged in which holders of financial assets continuously appraised the relative attractiveness of various near-money assets; yields were weighed in relation to liquidity and to the risk of capital losses (or possible gains) in the event of conversion into money. Higher short-term interest rates provided the incentive to move funds into these various near-money forms, but the ability and willingness of individual, corporate, and other holders of cash to reduce their cash balances to the minimum also reflected the success of financial intermediaries and final borrowers in providing attractive financial instruments. In addition, it has reflected the successful efforts of those who help provide a smooth and flexibly functioning money market. Incidentally, very much the same trend toward more economical use of cash balances—or, if you will, higher velocity of circulation of money—has taken place in a number of other countries, too.

While our money supply has declined markedly in relation to total spending in the economy (or gross national product), the total amount of liquid assets held by the public has grown alongside GNP, at a roughly comparable rate. And in fact, in the past few years nonbank liquid asset holdings have risen somewhat faster than total spending, so that the ratio of liquid assets to the annual rate of GNP increased from about 78 per cent in late 1961 to over 81 per cent last year. But before commenting on that increase, let me point out that, while the declining trend in money supply relative to GNP has persisted through the postwar period, it is only in the past few years that accelerated growth in time deposits of commercial banks has enabled the commercial banking system as a whole to maintain a roughly proportionate share of the economy's credit expansion. This has been desirable, I think, because banks are able, in terms of both technical facilities and experienced judgment, to place funds in a variety of alternative ways; this flexibility, with the banks picking and choosing among alternatives on the basis of yield and liquidity considerations, helps to produce an economically efficient result that has much to commend it.

As you know, some observers of the financial scene have expressed considerable misgivings over the slower growth in money supply proper, and the faster growth in near-money assets, compared with GNP, apparently feeling that the relative shrinkage of money supply also implies a diminution of influence for monetary policy. Such concern seems misplaced to me, however, for the very slowdown in growth of money supply, as excess liquidity was squeezed out or absorbed into minimum required working balances, has represented one of the successful results of monetary policy. So long as the monetary authorities retain an effective control over growth in the bank reserve base and the general climate of bank reserve availability, I believe that we have considerable influence over new credit formation. The fact that some of the newly created deposits shift out of the demand form into near-money assets endowed with varying degrees of liquidity is a significant development that we watch closely, but not a cause for concern since I think that these are factors we can take into account in providing marginal reserves to the banks with more or less alacrity or reluctance. The Federal Reserve's strategic influence on the over-all cost and availability of credit also tends to be preserved because financial intermediaries must maintain adequate cash working balances, usually in the form of demand deposits, and because the intermediaries rely on their ability to shift quickly between liquid assets and money, to meet fluctuating cash needs with minimum cash balances.

There might be greater cause for concern on this point if we had reason to expect large and sudden shifts, or desires to shift, from near-money assets to money, or if we had reason to anticipate sudden changes in the attractiveness of different types of liquid assets as money substitutes. On this score the experience of recent years provides some basis for confidence. While there have been some large shifts from one type of asset to another —such as from demand to time deposits—these shifts have not been so sudden as to throw our stabilization mechanism off balance.

Are these judgments altered because so much of the recent growth in near-money assets has been in the form of commercial bank time deposits? It could be argued that central bank influence is weakened because time deposit claims can be converted more readily into demand deposits than can some other types of liquid assets. Again, however, recent experience suggests no great volatility here—except perhaps for the artificial volatility that may emerge if the rates payable under Regulation Q become noncompetitive with market rates. On the other side it might even be argued that the increased proportion of near-money asset growth within the banking system has enhanced the position of monetary policy, in that such growth *within* the banking system may be a little more susceptible to central bank reserve influence. Of course, favorable recent experience is no proof that we will not experience future problems on this score.

I mentioned earlier that the recent period of expansion has been noteworthy not only for the enlarged financing role of commercial banks, but also because the over-all growth in credit and liquidity has been larger than usual for a period of business expansion. While the degree of monetary and credit ease has been reduced in the past two years, this reduction seems to have found little reflection in any lessened availability of bank funds for employment in new loans and higher yielding investments. It has been reflected, however, in the trend of bank holdings of Treasury securities, which is an area that often feels the first impact of monetary policy; in 1962, commercial banks refrained from adding to their holdings of Treasury securities, and in 1963 they reduced their holdings by some $3 billion to $4 billion. This disinvestment, of course, played a part in firming the level of short-term interest rates last year. It has probably had some effect on longer rates as well, although in such major areas as bank loans to business and home mortgage loans there has been no significant rate increase. In fact, for mortgage loans, a market in which increased bank participation has been of particular importance in the past two or three years, rates were still moving lower until the latter part of last year. The continuing ready availability of United States bank loans to foreigners is another indication of relative credit ease and substantial liquidity.

Without taking time here to review each segment of the credit markets in detail, I think it can be asserted with some confidence that after three years of business expansion and over two years of gradually lessened applications of ease from the central bank, we still have an ample availability of credit in this country. This shows up not only in the rate and volume trends I have alluded to, but also in the occasional outcroppings of poor credits. I do not by any means want to convey an impression that there has been a wholesale deterioration of credit standards, but I do think that the few well-publicized instances of unsound financing serve as timely reminders—first, that the over-all availability of credit is plentiful and, second, that while there is no way of determining precisely how much credit is just the right amount at any particular time, there is also no satisfactory substitute that I know of for sound, informed judgments in making individual loans and investments.

The large expansion of credit through banks and other financial institutions, and the sharp rise in nonbank liquidity that I mentioned earlier, are simply two sides of the same coin. And with liquidity, too, as with the volume of credit, there is to my knowledge no simple test that can determine whether this is now too high, too low, or just about right in relation to the economy. I do feel rather strongly, however, that the recent pace of increase bears careful watching as our resources become more fully utilized. The mere fact, also noted earlier, that the proportion of nonbank liquid assets to GNP has risen in the past two years, even though there has usually been a decline in periods of business expansion, is enough to give one pause.

I have been speaking thus far mainly about liquidity outside the banking system, which is the direct counterpart of credit extended by banks and through other financial intermediaries. As commercial and central bankers we are, of course, also concerned with liquidity within the banking system, which is a kind of fulcrum on which the central bank seeks to operate in order to affect the willingness of commercial banks to extend new credits. There are, of course, different ways of viewing bank liquidity, none of them right or wrong in themselves, but each adding a different perspective to this complex subject. Thus while the total reserves of member banks usually would not be included in measures of bank liquidity—if only because the bulk of such reserves is used simply to meet official requirements—I think this may make a useful starting point in considering the expansion potential in the banking system. By this standard—the size of total member bank reserves held with the Federal Reserve Banks or in the form of vault cash—there has been substantial growth in "bank credit potential" in the past two years, after including an appropriate allowance for the lower reserve requirement ratio against time deposits adopted some fourteen months ago. A good part of this growth, however, was needed merely to back the swiftly rising volume of time deposits.

At the same time, some portion of the increased reserves held by member banks was obtained through the "discount windows" of the various Federal Reserve Banks, and hence could not be regarded as having the same potential for credit expansion as the rest of the banks' reserves. Thus on the basis of so-called "nonborrowed reserves"—or reserves other than those obtained through the discount window—bank credit expansion potential grew more slowly. An even greater contrast is provided by considering the net "free reserve" position of the banking system, or excess reserves less borrowings from the Reserve Banks, which is usually considered part of the standard bank liquidity measures. This quantity, which has declined appreciably in the past two years, is a rough indicator that might be associated with the current unused margin of reserve availability; while it does not measure total bank liquidity, it is sometimes a sensitive indicator of the net pressures on banks to speed up or slow down the aggregate formation of credit and liquidity. We should be aware, however, that the significance of any given level of free reserves can vary greatly, depending on the pressure of demand for bank credit.

Bank liquidity, of course, comprises many elements in addition to the margin of free reserves held with the central bank. By and large these broader measures—such as ratios of loans to deposits and ratios of short-term liquid assets to deposits—suggest a decline in liquidity during the past few years, although of somewhat smaller proportions than in other business expansion periods. There should be nothing at all surprising in these declines. The banking system generally emerges from a period of recession and actively easy money with a relatively low proportion of loans and high proportion of liquid assets compared with deposits. As the expansion flowers, more attractive opportunities arise for putting funds to work profitably and safely, but in less liquid forms.

The thought occurs to me, however, that, given the major shift in the composition of bank deposits in recent years, the decline in these conventional measures of bank liquidity may not have quite the same significance as before. With a substantially larger portion of its deposit claims in the form of time rather than demand deposits, it would seem only natural for a bank to feel somewhat less constrained by particular loan-to-deposit or liquid asset-to-deposit ratios than it did before. Thus, while our usual measures of bank liquidity do show some decline in the past few years of business expansion and lessening credit ease, I feel that liquidity is still quite ample within as well as outside the banking system. Nevertheless, the decline in conventional measures of bank liquidity does mean that the banking system is, so to speak, on potentially closer rein than before. If it should happen that a sharply accelerated business expansion generated greater needs for cash balances and induced substantial switching from time to demand deposits, the decline of bank liquidity would have a sharper impact on bank lending and investment policies.

As we face the new year, the underlying economic situation seems to be about the same as in the past two years. There has been solid economic expansion, although not enough to eliminate a margin of excessive unemployment. And there has been a persisting balance-of-payments deficit which was materially reduced in the second half of last year but the elimination of which must continue to command our strongest exertions. In fact, the longer the deficit lasts, the more urgent its elimination becomes, if the dollar is to retain its status as the principal reserve currency. While the business expansion is now about three years old, it does not yet seem to have run out of steam, and prospects for an early tax cut should help to keep it moving along—perhaps even accelerate it. Fortunately, the Administration's current economy drive and streamlined budget should mean that there will be no great demand for additional Federal financing on top of the private demands that would be generated by further business expansion.

In coming months, we in the Federal Reserve System will be weighing the extent to which banks may appropriately supply a part of over-all credit and liquidity requirements. As in the past, we shall be guided by the continuing need to see the country's resources as fully employed as possible, but also by the need to avoid a build-up of demand pressures or of unnecessarily ample liquidity that would spill out in the form of upward price movements at home and further dollar outflows abroad. In short, we shall be trying to do the job for which the Congress created the Federal Reserve System fifty years ago. And in doing so, I know that we can count on the wholehearted and informed support of bankers throughout the country.