MEMORANDUM

March 13, 1967

TO: K. A. Randall, Chairman
    W. W. Sherrill, Director
    Federal Deposit Insurance Corporation

FROM: Allan H. Meltzer

SUBJECT: Regulation of Interest Rates on Time and Savings Accounts

Public Law 89-597 permits the Directors of the Corporation to "limit by regulation the rates of interest or dividends that may be paid by insured member banks." Passed as temporary legislation shortly after the peak of the so-called money market crisis of August, 1966, the law will expire at the end of one year. The question arises as to whether Public Law 89-597 should be renewed, amended or allowed to expire.

In this memo, I attempt to establish four main points:

(1) If interest rate ceilings at particular institutions are effective, these institutions will decline relative to unregulated institutions.

(2) The institutions whose growth would be fostered by regulation of interest rates include those where deposit insurance is not in effect.

(3) There is very little evidence that present or past regulation of interest rates on bank liabilities accomplished the purpose for which they were designed.

(4) A much more promising method can be devised to reduce or remove the problem which the present law and regulations were designed to meet.

One main conclusion reached is that there is no long-term benefit to be gained from regulation of interest rates on various types of time and savings deposits. The reason is that it is virtually impossible to control or limit
a few interest rates, when there are a number of alternative assets whose rates are uncontrolled. Even if the ceiling is extended to cover the liabilities of credit unions and other thrift institutions where rates are not now regulated, new types of financial instruments and new financial institutions will be devised to circumvent the regulations.

The second main conclusion is that because the regulations are effective for a short-period of time, they are a source of instability in the financial markets. There are two related reasons. First, the controls on rates are but one of many regulations affecting the institutions. They must be considered along with regulations directly affecting the asset side of the institutions' balance sheets. Second, most of the institutions are engaged in borrowing at short-term (accepting short-term liabilities) and lending at long-term. If changes in market rates are permitted while ceiling rates for deposits are maintained, variations in market interest rates will produce relatively large changes on the liabilities side of the institutions' balance sheets whenever the ceiling rates are effective. Indeed, this has been a main result of Federal Reserve Regulation Q during the periods in which it was effective.

In the following section, I provide some background against which recent experience can be judged and explore some of the long- and short-term effects of regulating interest rates in more detail. Then I offer some explanation of the problems that occurred in 1966 which led to the enactment of Public Law 89-597. Finally, I suggest an alternative to present regulations.
Some Short- and Long-Term Effects of Interest
Rate Regulation and Ceilings

Since the markets for financial assets, deposits and thrift accounts are highly competitive, the likely effect of ceilings on the interest rates paid by particular institutions on particular instruments is to limit the growth of the institutions or instruments whenever the ceilings are effective. Most financial institutions earn income by lending at long-term and borrowing (or accepting deposits) with potentially short term to maturity. Many of these institutions are restricted on the asset side of their portfolios to a small range of assets. When the supply of particular assets (such as mortgages) increases, their yields rise and the institutions that specialize in these assets offer higher yields to attract deposits from the public and from other institutions. If ceiling rates prevent a particular institution from attracting deposits by raising rates, some other institution acquires the asset. The ceiling rates do not prevent market rates from rising. They merely restrict the growth of particular institutions.

This point is at the center of the problem of interest rate regulation. To see the point more clearly, suppose that a set of regulations like the one promulgated under P. L. 89-597 had been in effect throughout the year 1966. Given an unchanged monetary and fiscal policy, there is no reason to believe that the regulations would have reduced the pressure on existing intermediaries. If rates had been controlled so that commercial banks could not have attracted deposits from savings and loans, there would have been less expansion of credit by commercial banks. But given the level of market interest rates and the expanded demand for credit by business and
households, some other institutions would have found it profitable to offer higher interest payments on deposits and thus would have attracted deposits from both savings and loans and commercial banks. Or, individuals and business firms would have acquired securities directly from issuers rather than purchasing certificates of deposit and allowing banks and non-banks to acquire securities and make loans.

The rise in market interest rates and in rates paid on commercial bank time deposits attracted deposits from foreigners and from foreign institutions just as it attracted deposits to commercial banks from domestic institutions. Had the ceiling rate prevented the commercial banks from attracting foreign deposits into negotiable certificates, foreigners would have acquired Treasury bills, government bonds and corporate securities.

In short, if the ceiling rates had been in effect throughout the year, the pressure created by withdrawals of interest bearing deposits from existing institutions in search of higher yields would not have been reduced. Either individuals, corporations or institutions whose liabilities are not insured would have acquired assets.

Over a longer-term, there can be one of three results if ceiling rates are maintained at some institutions while interest rates at other institutions remain unregulated:

(1) Either new financial institutions not subject to the ceiling will develop to lend at long-term and borrow at short-term, or unregulated institutions will grow relative to regulated institutions. (For example, the growth rate of credit unions will accelerate.)

(2) Or, on the average individuals and corporations will hold a larger share of securities directly rather than through intermediaries.
(3) Or, the ceiling rates will be adjusted in response to changes in market interest rates. (This is perhaps the worst of the three alternatives for reasons noted below in the discussion of Federal Reserve Regulation Q).

Comparison With The Effect of Regulation Q

Another way of viewing the problem created by the new ceiling rates is through a brief discussion of Federal Reserve Regulation Q. Through most of the period since 1935, this regulation was not effective and was of no concern. When market interest rates rose in recent years, rates on time deposits reached the ceiling rate. Each time this happened, the Federal Reserve raised the ceiling rate to increase the flow of time deposits to commercial banks.

The Federal Reserve always operated with a lag, that is, after pressure had built up for an increase in the ceiling rate. This pressure was not evenly distributed throughout the banking system. The deposits at some banks were more affected by the changes in market interest rates, and these banks generally were most anxious to increase interest rates paid on liabilities when interest rates on bank earning assets rose. This process of interest rate adjustment occurred again last year.

In the latter half of 1965 and early 1966, the Federal Reserve supplied reserves and currency (base money) at an average annual rate of 6% — approximately twice the average long-term growth rate of the base. The high and increased rate of expansion came after a prolonged period of rising output and a very large increase in the demand by business and consumers for credit from banks and other financial institutions. Interest rates rose in response to the increa
rate of demand. Indeed the increase in demand was so great that interest rates rose despite the very large increase in the rate of monetary expansion provided by the Federal Reserve. The rise in market interest rates sent businessmen and individuals in search of higher yields. To keep banks from losing time deposits, ceiling rates under Regulation Q were increased in December, 1965.

If Regulation Q ceiling rates had not been increased, corporations and individuals would have responded to rising rates by purchasing securities directly (Treasury bills, bonds, etc.) rather than by holding deposits at commercial banks or purchasing negotiable certificates of deposit. Given the demand to borrow in the economy, the rise in market interest rates could not have been avoided by a refusal to change Regulation Q. The main effects of the failure to permit commercial banks to pay higher rates on deposits would have been a slower growth rate of deposits at commercial banks and a larger amount of direct purchases of securities by individuals and corporations.

The experience with Regulation Q in 1965-66 was a repetition (in exaggerated form) of the effect of each of the earlier changes in Regulation Q. Each prior change in the ceiling rates established under Q resulted in a substantial amount of deposit and asset reallocation by the public between types of deposits and between banks and non-banks. The difference in 1965-66 was that unlike earlier periods, the construction of houses had slowed, the supply of new mortgages was growing much more slowly than in earlier years and the savings and loan associations were less able to compete for deposits with commercial banks. Hence, the diversion of deposits from savings and loan associations to commercial banks was larger than on previous occasions.

Again, I must emphasize that — given the expansion in demand, in borrowing and hence in market interest rates during the latter part of 1965 and the first
quarter of 1966 — the issue is not whether the diversion of deposits from savings and loans to commercial banks could have been avoided. If the Federal Reserve had not raised Regulation Q rates, the flow to commercial bank time deposits (including C.D.'s) would have been smaller or negative. But, there is no reason to believe that the diversion of deposits from savings and loans would have been affected greatly. Individuals and corporations would have acquired the securities directly and the savings and loans would have been under approximately the same pressure they experienced during the year.

In short, the difficult position of the savings and loans in 1966 was mainly a result of the decline in construction and the reduced supply of mortgages. Construction activity turned down well in advance of the rises in market interest rates, although the rise in market interest rates depressed construction further. Since savings and loans are prevented in most states from lending on assets other than mortgages, they were not able to compete profitably with commercial banks for interest bearing deposits.

Policies and Problems in 1966

Market interest rates reached a temporary peak in March and what now appears to be a more permanent peak in late summer. These two peaks occurred for very different reasons. It is important to distinguish between them and to question the policies that led to the very sharp rise in interest rates during the late summer. It was the latter rise that led directly to P.L. 89-597.

The rise in interest rates during the early and late winter occurred despite an expansionist Federal Reserve policy — one of the most expansive policies in peacetime years. Interest rose because loan demand and other demands for credit rose more rapidly than the monetary base.
The increase in the growth rate of the monetary base coming at the end of the longest period of monetary expansion in peacetime history was inflationary as was evident to all later in the year. Because of the Federal Reserve's traditional concern for money market conditions and market interest rates, they interpreted the rise in market interest rates as a sign that monetary policy was restrictive and continued to supply reserves and currency at an inflationary rate.

Rising prices eventually convinced the Federal Reserve to reduce the rate of monetary expansion. As usual, they reversed direction with a vengeance. The average growth rate of the monetary base (seasonally adjusted) fell from the 6% rate of the first half of the year to -7% in August. Interest rates rose dramatically, this time due to the sharp change in the direction of monetary policy. Many savings and loans and some commercial banks experienced an accelerated outflow of deposits as individuals and corporations attempted to take advantage of the relatively high yields available in the market.

Since the peak rates of August, the demand for loans and for credit has slowed because of slower pace of economic activity. Most of the decline in interest rates during the fall appears to be a result of the decline in demand. The growth rate of the monetary base suggests that the Federal Reserve has pursued a much more contractive policy than the policy of early 1966. As usual, they appear to be beguiled by the fall in interest rates into the belief that their policy is expansive.

The effect of the decline in market rates with savings and loan rates unchanged has been a return of deposits to savings and loans. This is the typical pattern at this stage of the cycle. There is no reason to believe that the ceiling rates have had any important effect on these flows.
My analysis suggests that the long delay before the growth rate of money was reduced and the very sharp change in the direction of monetary policy produced a shurning of the financial markets that could have been avoided. If monetary policy had not been as expansive in 1965 and early 1966, both the inflation and the size of the reversal in policy would have been smaller; if the Federal Reserve had not over-reacted during the summer, the size of interest rate changes would have been smaller at the time. As a result, the reallocation from savings and loans and other institutions would have been smaller and we might have avoided imposing additional controls on interest payments by commercial banks.

This should not suggest that the flows from savings and loans to commercial banks do not pose a problem. In the following section, I discuss what I regard as the main source of the problem and propose a solution. The points to be emphasized here are: (1) that part of the problem experienced last year could have been avoided if the Federal Reserve had not expanded too much in the winter and contracted too much in the summer; and (2) that there is no reason to believe that the adjustment would have been easier if the ceiling rates had been in effect earlier in the year.

An Alternative Solution

The variability of monetary and fiscal policies and the acceleration and deceleration of monetary and fiscal changes is one main cause of the reallocation of deposits between banks and intermediaries. P.L. 89-597 has no effect on this source of instability.
Another main cause of reallocations from one institution to another is the variation in the growth rates of particular financial assets such as mortgages. When mortgage yields are rising savings and loans bid for deposits by offering higher returns to depositors. P.L. 80-597 attempts to meet this problem, in part, by preventing large changes in the liabilities of specialized institutions. There is no reason to expect the regulations of interest rates on liabilities to affect interest rates on assets such as mortgages or the growth rate of such assets.

Much of the problem of asset reallocation arises because of the specialized nature of the many financial institutions. This specialization is in part the result of choice by the institutions and in part the result of regulations which limit the choice of assets that particular types of institutions can acquire.

When there is a substantial decline in the relative growth rate of demand for mortgage loans, savings and loan associations cannot offer holders of their liabilities a rate of interest as high as the rate paid by competing financial institutions. Moreover, any increase in deposit rates must be paid on existing as well as on new deposits, while asset yields increase on only a limited amount of new mortgages. The competitive position of savings and loans declines. As a consequence, commercial banks are able to bid deposits away from savings and loans.

The reason that commercial banks can offer higher rates to depositors is that they can acquire a wider range of assets with rising yields. They are not restricted to a particular type of asset or to a particular range of maturities, so their earnings are much less affected by a reduction in the supply of particular instruments. Clearly, if savings and loan's had been permitted to invest in a larger range of assets — consumer credit, term loans, corporate bonds — they
would have been in a much better position to compete with commercial banks, and
the flow of deposits from savings and loans to commercial banks would
have been smaller.

Experience in 1966 showed that present restrictions on the types of assets
that savings and loans can acquire poses a problem in periods of rising rates
when — as is usually true — there are changes in the relative rates of
growth of various types of financial assets. Since savings and loans lend
at long-term and borrow or issue deposits that (in practice) are payable on
demand, losses of deposits threaten the liquidity position of these institutions.

The severity of the problem can be reduced by removing restrictions on the
types of assets that savings and loans and similar institutions are permitted
to purchase. By permitting a different mix, their ability to pay competitive
rates on deposits is maintained. There is then less reason for the reallocation
to take place, hence there is less threat to the liquidity of well managed
institutions.

Conclusion

If the regulations promulgated under P.L. 89-597 are retained, there is
substantial reason to believe that our experience in the future will differ
little from our experience in 1966. Either the ceiling rates will rise with
market rates on assets acquired by banks and non-banks, or the regulated
institutions will lose deposits to unregulated institutions.

The principal reason for the substantial reallocation of deposits and
redirection of savings in 1966 are: (1) the variability of monetary and
fiscal policies and (2) the restrictions on types of assets that particular
institutions can acquire. If the savings and loans were given authority to
invest in a larger range of assets, there would be much less variability in the relative growth rates of bank and non-bank institutions because there would be smaller reallocations of deposits from one type of institution to the other.