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CONFIDENTIAL

Date: March 15, 1963

To: Mr. Ellis

From: P. S. Anderson

Subject: Comments on papers distributed at last F.O.M.C. meeting.

A general impression gained from the discussion in these papers concerning probable effects of monetary restraint is that a restraint program encounters difficulties in alleviating the payments deficit (e.g., one common conclusion was that the end result might actually be unfavorable in its Euro-dollar effects) but at the same time restraint can have marked effects on domestic business activity (e.g., the threat of a "deflationary spiral"). It is only fair to note that such impressions were probably not intended, but rather resulted from the subjective balancing of the pros and cons of assumed policies. The following discussion first analyzes in depth one area, the alleged discrimination by American banks during periods of restraint against domestic borrowers and in favor of foreign borrowers whose names are "well and favorably known" and then briefly touches upon other points in these papers.

Would American Banks Favor Foreign over Domestic Borrowers?

Opinions expressed in several of these papers regarding the relative attitudes of American banks toward foreign and domestic borrowers were that domestic banks were either neutral, i.e., nondiscriminatory, (Paper 2, p.10) or else actually favored foreign borrowers (Paper 5, p.5). It will be contended here that American banks clearly favor domestic borrowers in the usual situation. This attitude is important, not only because it has an impact on the balance of payments, but also because the reactions of banks under conditions of restraint have implications for the general effects on the domestic economy.

In comparing the relative attractiveness of domestic vs. foreign borrowing the first step in the analysis will be to assume equal credit-worthiness, i.e., both types of borrowers should be "well and favorably known" which means that the domestic

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borrower should be large enough to be internationally recognized. With this assumed equality in size and credit rating the attractiveness of the two types of borrowers depends in large part on collateral benefits of various types. At the outset it is apparent that banks prize their domestic customers of this type. For example, they pick most of their directors from companies in this category. It seems hardly likely that a bank would reject the loan application of a company which it valued enough to tap for a director.

Probably the chief value of the patronage of a high grade domestic customer lies in the working demand balances which the bank obtains. Demand deposits are the foundation of the commercial bank. While the foreign borrower might be required to maintain a compensating balance, this seldom amounts to as much as the working balances of a domestic borrower. (This "idle" compensating balance is, in itself, discriminatory against the foreign borrower). Furthermore, the domestic working balance will remain in the future even when the borrowing is repaid while the foreign borrower is hardly likely to waste resources in this fashion. (If the foreign borrower has a need for American working balances, that part of his business is American, and therefore cannot analytically be classified as foreign).

Collateral services which a bank can expect to supply (at a profit) to a satisfied domestic borrower which a foreign borrower is unlikely to use either at all or in equal amount include the following:

1. Registrar of stocks and bonds
2. Corporate transfer agent
3. Pension trustee
4. Profit-sharing trustee
5. Safe-deposit and safe-keeping
6. Lock box service
7. Bookkeeping and payroll accounting
8. In-plant banking

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Commercial bankers express the opinion that all these benefits from a satisfied domestic customer make the domestic loan preferable to a foreign loan even if the foreign loan has a rate that is a full one percentage point higher. It seems not unreasonable, however, to go even further and make the claim that if, in a specific case, only one borrower, as between a domestic and a foreign firm, can be accomodated as a result of progressive and genuine tightness, the domestic firm will be chosen whatever the relative loan rates. The presence of eager foreign borrowers will, of course, push domestic rates up.

Thus far the comparison has involved domestic borrowers of large size and good rating. Even if this type of borrower did more than hold its own against foreign borrowers under conditions of restraint, that would be small comfort for the smaller, and possibly more marginal, domestic borrowers. How do smaller borrowers fare under restraint? It has been commonly assumed that small borrows are "rationed out" when availability declines. But a comprehensive analysis by G.L. Bach and C.J. Huizenga of the 1955 and 1957 business loan surveys of the Federal Reserve System refutes this common assumption.[1]

They found that there was no indication that those banks that were "tightest" in 1957 were more restrictive in their credit to small borrowers than banks that were "loosest". This conclusion probably again reflects the same general attitude as described with regard to domestic and foreign borrowers. Commercial banks simply will not extend credit to a new, outside borrower, even though large, if this requires denying credit to an established local customer, small though he may be.

But monetary restraint does appear to have at least one differential effect--it impinges hardest on the biggest banks that are most active in lending to foreign borrowers. Reserves of New York and Chicago banks increased less or declined more during postwar periods of restraint than reserves of banks elsewhere, and similarly reserves of Reserve City banks in-

[1] American Economic Review, March 1961, pp. 18-51.

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creased less or declined more than reserves of country banks. The record is as follows:

Percent change in total average daily reserves

	Jan. to April 1952 to Jan. to April 1953	April to Sept. 1955 to April to Sept. 1957	Jan. to Dec. 1958 to Jan. to Dec. 1959
New York	-2.8	-2.3	-3.7
Chicago	3.1	-1.7	-4.5
Reserve City	3.2	1.3	-0.1
Country	4.7	4.3	2.6

What type of portfolio adjustments might big banks make in response to restraint? Paper 1 (pp. 13-14) indicates that most of the reduction would fall on municipals and mortgages but there is a likelihood that the impact will fall on all types of assets in a more balanced way. It may be recalled that during the 1955-57 period it was commonly assumed that consumer loans were immune from restraint. But, as shown in the chart on the following page, large banks that were tightest -- those that had the smallest deposit increases or actual decreases -- did show an impact with respect to consumer loans (which are the highest yielding assets banks own). Currently monetary restraint would undoubtedly have an even more balanced impact on bank assets because banks' total government security holdings are a much lower proportion of total assets than in 1955.

It needs to be noted, however, that despite the fact that these various special factors serve to reinforce the general salutary effect on the balance of payments of reduced monetary availability, direct bank lending is but a small part of the total problem. The more complete solution lies, of course, in the direction of the influence of restraint in accomplishing a balance by reducing domestic monetary availability while at the same time raising domestic goods' desireability through stable or lower prices.

Deflationary Spirals and Other Effects

It seems appropriate to question the relevance of a thought expressed several times, namely that a foreseeable degree of monetary restraint may instigate a "deflationary spiral". It would take a tremendous change in attitudes to induce marked

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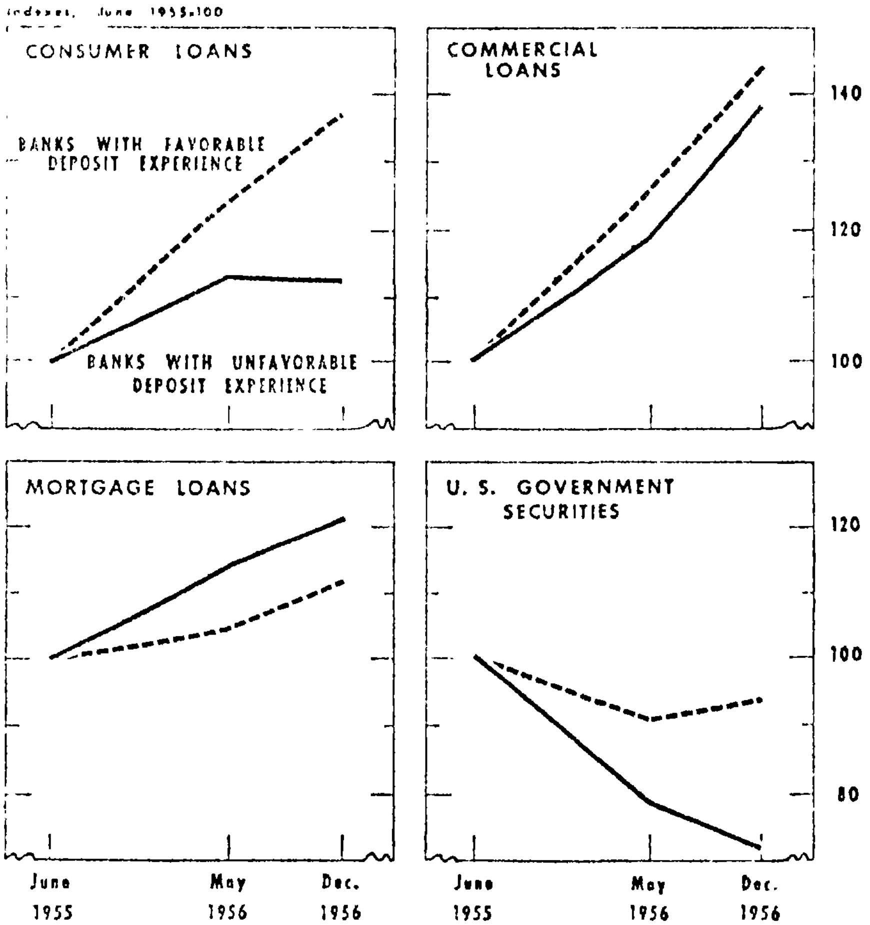
CHART 1

CHANGES IN LOANS AND SECURITIES - LARGE BANKS



Note: May was used as a dividing point for the entire period because reserve positions reached their tightest point (as indicated by the excess of borrowings over excess reserves) in that month.

(From Paul Smith, "Consumer Loans and General Credit Conditions", American Economic Review, September 1958, p. 651).

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deflationary expectations in any modern economy. So far as American financial history is concerned, sharp commodity price declines have only occurred under two circumstances, postwar price readjustments--1815, 1865 and 1920--and widespread bank failures as evidenced by payments suspensions--1837, 1857 and 1930-1932. If such a price decline were to occur under present conditions, it should be treated as an unprecedented phenomenon rather than as a more or less normal result of restraint.

One frequently noted aspect of relative domestic and foreign effects of restraint is that domestic interest rate rises would cause foreign rates to rise, especially through Euro-dollar effects, thus nullifying the beneficial effects of domestic restraint. This reasoning seems to imply that the volume of Euro-dollar flows is so large as to dominate foreign rate levels. But other references indicate that flows to and from the Euro-dollar market are quite small. If the latter is true, then foreign rate levels will be affected little by Euro-dollar rates. But obviously if Euro-dollars are going to be used, their rates have to be competitive with resident rates.

Undue emphasis on rate levels, however, can lead to inconsistencies. For example, Paper 1 (p. 13) assumes that higher rates mean no dimunition in the total flow of savings which certainly seems reasonable by itself. Elsewhere (p. 17) it assumes that higher rates will be accompanied by a decline in business, residential and state and local outlays. But these assumptions are inconsistent -- rates cannot rise if savings rise while borrowings fall. More generally, as the economy adjusts to reduced availability and reduced monetary flows, the same volume of real saving and investing as formerly can be accomplished with no rise in rates.

The crucial domestic question is the adjustment that might be made to reduced availability and at least temporarily higher rates. Current economic developments seem pertinent to such speculation. Declining long-term rates during the past year and a half have been associated with a disappointing level of plant and equipment outlays. The most recent survey, however, shows a reversal from former pessimism.

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It can be submitted that this reversal has nothing to do with rates but reflects the continued strength in retail sales. In the private sector, retail sales are, after all, the ultimate pay-out of capital expenditures. If retail sales continue strong, it is unlikely that foreseeable changes in rates would dissuade individual producers from maintaining their shares of capacity.