



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

JUN 11 1962

June 11, 1962

CONFIDENTIAL (FR)

TO: Federal Open Market Committee

FROM: Mr. Young

Attached is a memorandum prepared by Mr. Brill summarizing remarks he recently presented to the Board on the liquidity position of the United States Economy in Early 1962. Chairman Martin feels that this would be of interest to all members of the Open Market Committee. An additional copy is enclosed in order that it may be made available to members of your staff.

A handwritten signature in cursive script that reads "Ralph A. Young".

Ralph A. Young, Secretary,
Federal Open Market Committee.

Attachment

JUN 1 1 1962

Liquidity Position of the U. S. Economy in Early 1962

Liquidity is among the more elusive and controversial of economic concepts, ranking with "savings" and "capital formation" in conceptual ambiguity and difficulty of measurement. There is no single total or ratio that defines liquidity for all times, for all economies, or for all transactors. At best, therefore, one can only deal specifically and in detail with given situations in order to attempt a judgment as to whether an economy at a particular stage of maturity and in a particular cyclical phase is adequately liquid, dangerously liquid, or illiquid.

This brief note does not attempt to resolve the many conceptual difficulties surrounding the subject, nor does it advance any major innovation in measurement. The analysis is limited to the few, fairly widely used measures relating to the U. S. economy in the spring of 1962 that can be constructed with reasonable accuracy and within a limited time period. The sequence of analysis will be to look first at the liquidity of private nonfinancial sectors in the aggregate and by major subgroups, comparing their present position with that in earlier postwar cycles, and then examine the liquidity of the commercial banking system.

The Private Nonfinancial Sectors of the Economy

Liquid assets have tended to rise consistently over the past decade, as is shown in Chart 1, with only small changes in the slope of the trend and only minor cyclical fluctuations. There have been significant changes in the composition of these assets, with active money--demand deposits and currency--displaced in part by interest-bearing liquid assets. The total of liquid asset holdings, however (defined here to include, in addition to active money, time and savings deposits and shares, U. S. savings bonds, and short-term U. S. Government securities), has continued to rise, with the increase over the past five years just about keeping pace with the rise in the total value of economic activity.

With the uptrend in liquid asset holdings relatively constant, cyclical fluctuations in the liquidity ratio (shown on Chart 2) have reflected largely changes in the denominator, i.e., in the value of output. As output has declined in the contracting phases of cycles, the liquidity ratio has risen; as the trend in activity has reversed, the liquidity ratio has declined.^{1/}

^{1/} The liquid asset line shown on Chart 1 relates to the total amount of such liquidity instruments outstanding in the economy. The ratios shown on Chart 2 relate to the holdings of such instruments by private nonfinancial sectors only (consumers, businesses and State and local governments). The exclusion of liquid asset holdings by financial sectors affects the level of the ratios, but not the trend of the ratio line.

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In the most recent cycle--from the peak in the spring of 1960 to the trough in the winter of 1961, and the subsequent recovery and renewed expansion to date--liquid assets increased rapidly during both contraction and expansion phases. The decline in GNP from early 1960 to early 1961 was mild, but the recovery in 1961 was rapid and exceeded the pace of liquid asset growth. As a result, the liquidity ratio dropped last year at roughly the same pace as in earlier recovery periods. There has been an increase in the ratio in the first three months of 1962, but the rise has been small and has resulted not so much from an acceleration in liquid asset growth as from a faltering of GNP in its path of cyclical expansion. As a rough guess, one might venture that the ratio is leveling off or declining slightly in the current quarter.

Consumer liquidity. Movements in aggregate liquidity measures are usually dominated by changes in consumer and corporate assets, debts, income and spending. The liquidity position of consumers, which is one influence on their willingness to increase spending relative to income, can be judged from two perspectives--their capacity to borrow and their liquid asset position.

Capacity to borrow is indicated to some extent by the burden that contractual payments of various types impose on current income.^{1/} The ratio of such payments to disposable income (shown on Chart 3) has been essentially unchanged since 1957, at close to the 1939 level, with the 1961 ratio slightly above the average for the period. Whether this represents a saturation level, given the present distribution of incomes and incidence of indebtedness, cannot be determined, but the relative stability in the payments ratio through two cycles suggests that, in the absence of a strong stimulus such as a marked easing in repayment terms, consumers are not likely to increase their borrowing much more rapidly in the near-term than incomes are likely to rise.

Liquid asset holdings of consumers have borne a reasonably close relation to income over the past ten years, with the ratio of assets to income moving between 75 and 80 per cent. The ratio rose sharply during the 1960-61 recession and, in contrast with previous recovery periods, has remained close to the high level of early 1961 since then. This high-level stability of the liquidity ratio through the recent recovery was undoubtedly related to the lack of vigor in consumer spending, which, in real terms, rose less relative to incomes than in any of the earlier postwar recoveries. Increased spending in March, April and May may be bringing some reversal in the trend of the ratio, unless the shakeout in stock prices results in accelerated transfer of consumer funds into liquid instruments.

^{1/} "Fixed payments" are defined here to include repayments of instalment credit, interest and amortization of home mortgages, taxes on houses owned, rents, and life insurance premiums.

In summary, the two measures of consumer liquidity attributed here appear to suggest contradictory conclusions, with the burden of contractual obligations high and apparently at a ceiling, but liquid asset holdings relative to incomes also high. Much more needs to be known about the income and demographic distribution of assets and debts currently before one can adequately assess the relative inhibiting effects of debt burden versus the stimulating effects of liquid asset holdings.

Corporate liquidity. The ratio of corporate liquid asset holdings--cash and U.S. Government securities--to total current liabilities was 36.3 per cent at the end of 1961, the lowest fourth quarter on record.^{1/} This ratio declined sharply during 1955 and 1956, from about 52 per cent to 40 per cent, and fluctuated around the latter level until 1960 when it declined again to the 35-36 per cent range in which it has moved for the past year and a half. Very preliminary figures indicate that this measure of corporate liquidity declined further in the first quarter of 1962, with the drop apparently somewhat greater than usual for this time of year. These preliminary estimates show a large decline--on the order of \$3 billion--in corporate total cash balances in the first quarter of the year. Given the fragmentary information available on time certificates of deposits, the change in total corporate cash suggests a very sharp decline in corporate demand deposits.

The postwar course of the liquidity ratio has included several sharp downward steps to a new plateau that was maintained for some period, as Chart 5 shows. At each lower plateau, many observers have felt that corporations must feel pressed for liquidity and could be expected to make efforts to build up their liquidity ratios toward previous levels, but this has not happened. Thus, one cannot say either that corporations must consider their liquidity "too low" at present, or that recent levels represent a floor and are not likely to be reduced further. It does seem clear, however, that current liquidity relationships provide less leeway than in earlier expansions for further reductions to finance capital and other outlays.

Over the past decade, the range of assets in which corporations hold their liquidity has widened appreciably, and it is often (and properly) contended that a ratio relating only cash and Governments to current debts does not adequately measure relative liquid resources of corporate business. Even if one widens the definition of liquid assets to include the entire "other current asset" category, where corporations often classify their holdings of finance company paper, municipal warrants, etc., the trend in the liquidity ratio would still be sharply down. From a high of 55 per cent at the end of 1952, the ratio of cash, Governments and other current assets to current liabilities declined to 43 per cent at the end of 1961, compared with a drop from 53 per cent to 36 per cent in the conventional ratio, with

^{1/} Quarterly data are available only for manufacturing corporations.

identical cyclical timing in changes over the decade. The broader measure of corporate liquidity also declined in early 1962, according to preliminary estimates of the SEC.

The ratio of liquid assets to sales has also been at historically low levels recently. The sharp rise in sales over the last three quarters of 1961 was accompanied by a much smaller rise in liquid assets, and the ratio between the two was reduced to less than 30 per cent. In contrast, the ratio ranged between 42 and 44 per cent in most quarters of 1954 and 1955; in 1958, when sales also rose sharply, the ratio showed only seasonal changes.

Liquidity of Commercial Banks

There are several aggregate measures of commercial bank liquidity, relating various elements of bank portfolios to various components of their liabilities. No one measure is completely satisfactory. Often movements of the several widely used series are contradictory, and all must be interpreted within the context of the changing structure of bank assets and liabilities.

One conventional measure--the ratio of bank loans to total deposits--currently suggests that the illiquidity of banks is relatively high. This ratio, which has shown a rising trend during the postwar period, reached a peak in mid-1960 at about the outset of the last recession (Chart 6). The ratio declined somewhat during the economic contraction, but the drop was less than in 1957-58. During the recovery, however, the ratio was relatively stable, in contrast with the rapid increase during the 1958-59 recovery, and the level of the ratio at the end of April 1962 was only 1-1/2 per cent below its postwar peak.

The stability in the ratio in the 1960-62 period contrasts with earlier experience, and reflects both the more moderate growth in loan demands in this cycle and the larger rise in deposits, particularly time deposits. From the trough in 1958 to June 1959, total loans at all commercial banks rose 10 per cent, while total deposits increased 6 per cent. In the comparable period in this recovery (from February 1961 to April 1962), loans rose only 8 per cent, but total deposits increased by about the same amount. Almost all of the increase in deposits this time was in time and savings accounts, whereas these deposits accounted for only half of the rise in total deposits during the 1958-59 period (Chart 7).

In view of bank portfolio management in reaction to the rise in time and savings deposits, it has been suggested that the ratio of loans to deposits should be modified to include bank holdings of State and local government securities in the numerator, particularly since the present calculation already includes one type of bank asset through

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which banks have responded to the rise in their longer term liabilities, namely, mortgage loans. If State and local securities are included in the calculation, then the modified ratio--loans plus municipals/total deposits--would currently be back to its earlier postwar peak.

In contrast with the stability shown in the loan/deposit ratio over the 1960-61 cycle and to date, another widely used measure of bank liquidity--the ratio of short-term Government securities plus free reserves to demand deposits--increased sharply from the recession low to mid-1961 and has remained relatively high since then. With loan demands moderate and reserves readily available, banks added substantially to their holdings of short-term Government securities. Incentives to portfolio shortening were the comparatively high yields maintained on Treasury bills, in part by Treasury and Federal Reserve operations, and the recollection of 1957-58 experience, when banks had invested heavily in longer term issues and were subsequently faced with sharply reduced prices when they had to sell securities to meet loan demand. Although in recent months bank holdings of short-term Government securities have been reduced and investment portfolio maturities generally lengthened, the ratio of liquid assets to demand deposits is still close to its recent high.

There can be some reservations as to the significance of the ratio of liquid assets to demand deposits alone in the current period, in that some of the time deposit increase, particularly since the beginning of this year, may prove much more volatile than usual. To the extent that the rise in time liabilities reflected shifts of funds by businesses and other active investors in response to changing interest rate relationships and working capital needs, these are subject to reversal if market interest rates rise and business needs for capital increase.

Pressure on bank liquidity from an increase in loan demands or from a loss of volatile time deposits could be met by allowing some of their relatively large portfolios of short-term Governments to run off. Bank holdings of Government securities maturing within a year are currently about \$23 billion, and during previous periods of loan expansion the total has been reduced to as low as \$7 or \$8 billion. Whether such run-off or other liquidation of bank short-term Government portfolios would have a significant effect on market rates would depend, in part, on the capacity and willingness of nonbank sectors to absorb additional Governments, as well as on the Treasury's financing needs and plans at the time.

Division of Research and Statistics
Board of Governors of the
Federal Reserve System
June 11, 1962

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Chart 1

GROSS NATIONAL PRODUCT AND LIQUID ASSETS

Ratio scale, billions of dollars

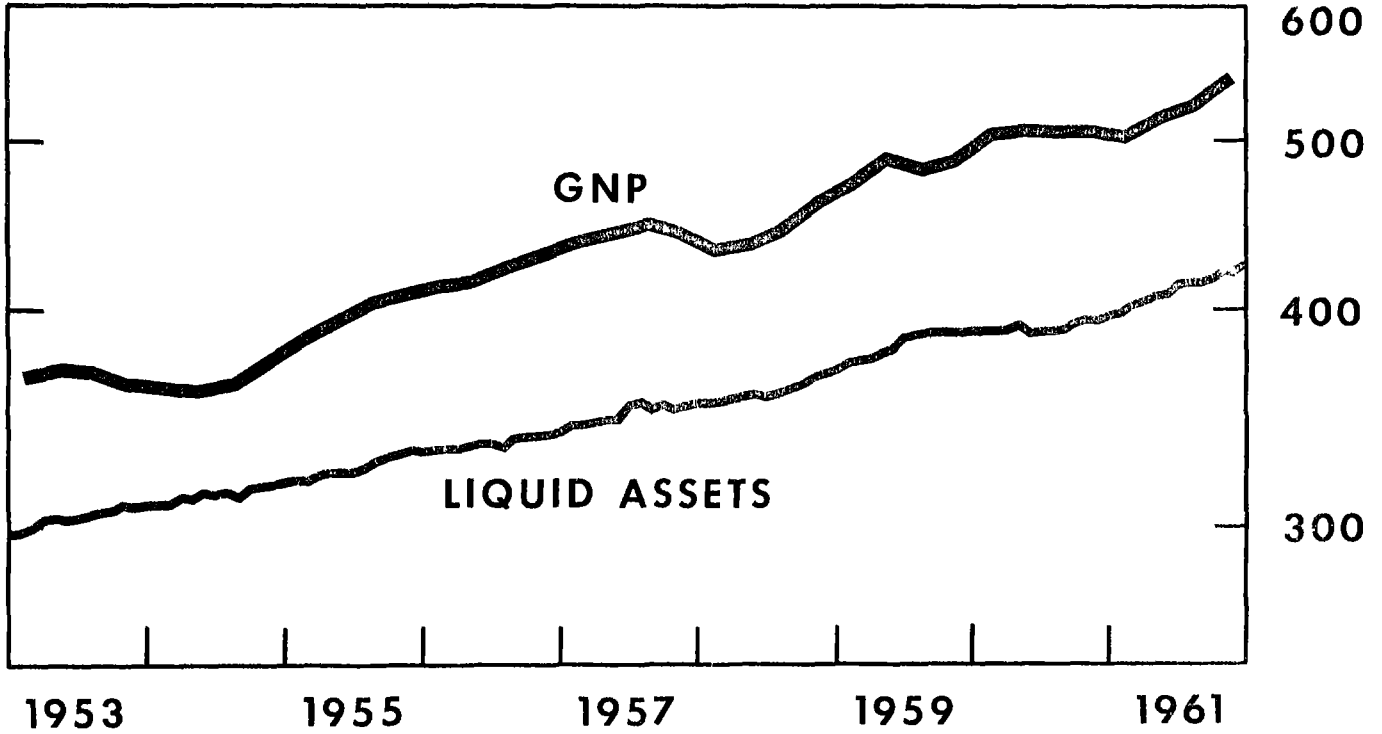


Chart 2

PRIVATE DOMESTIC LIQUIDITY

Ratio scale
Per cent of GNP

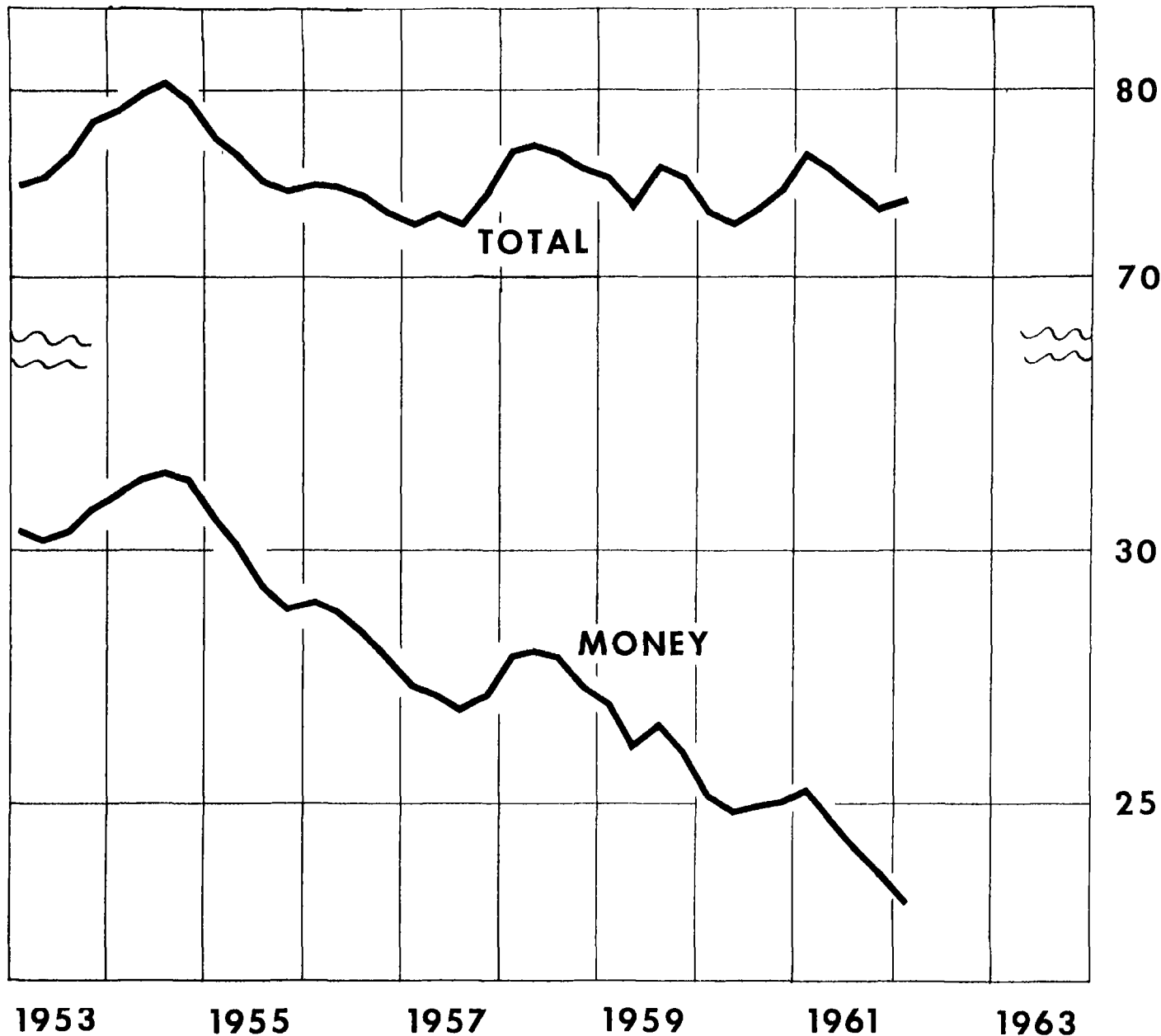


Chart 3

CONSUMER FIXED PAYMENTS

Per cent of
disposable income

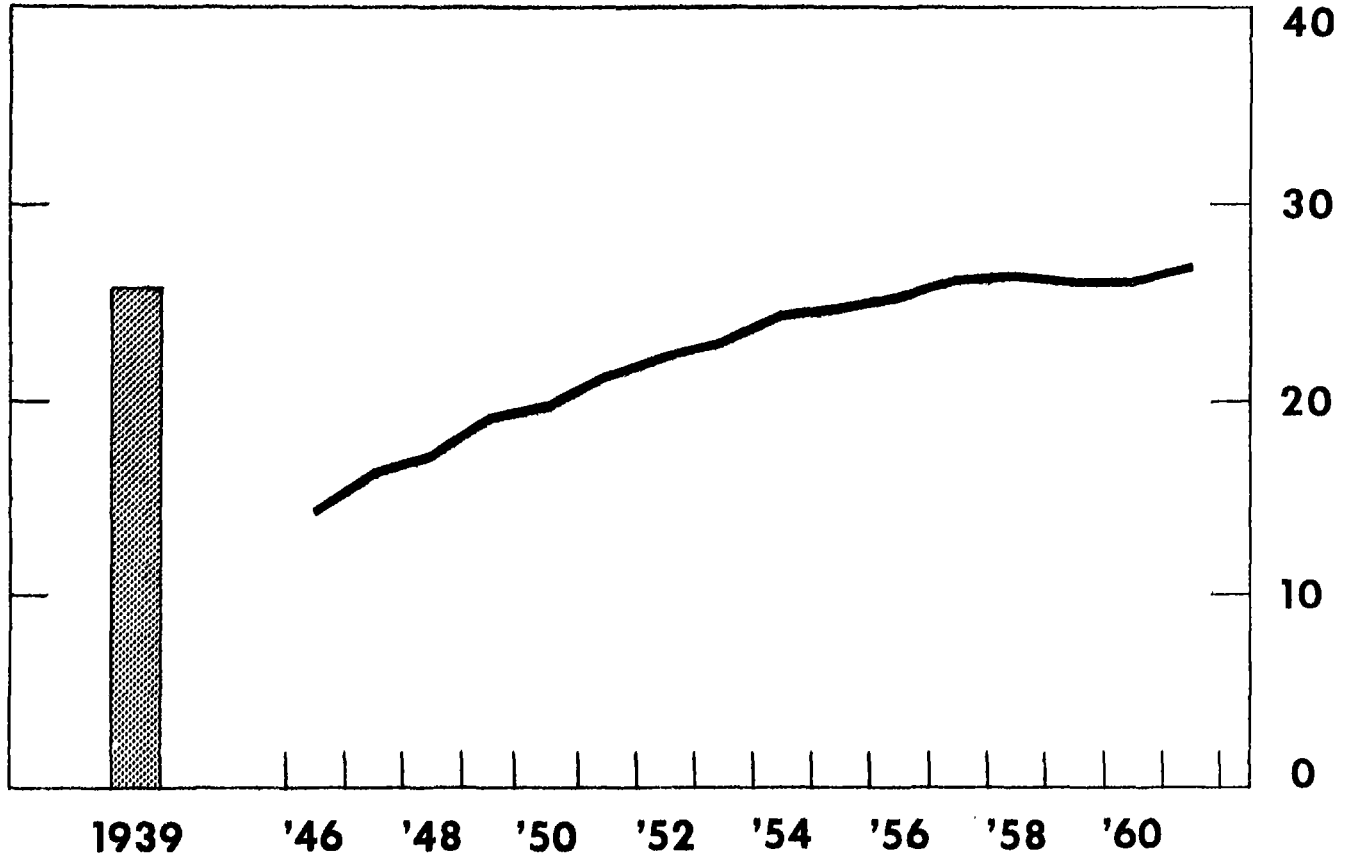


Chart 4

CONSUMER LIQUID ASSETS

Ratio scale
Billions of dollars

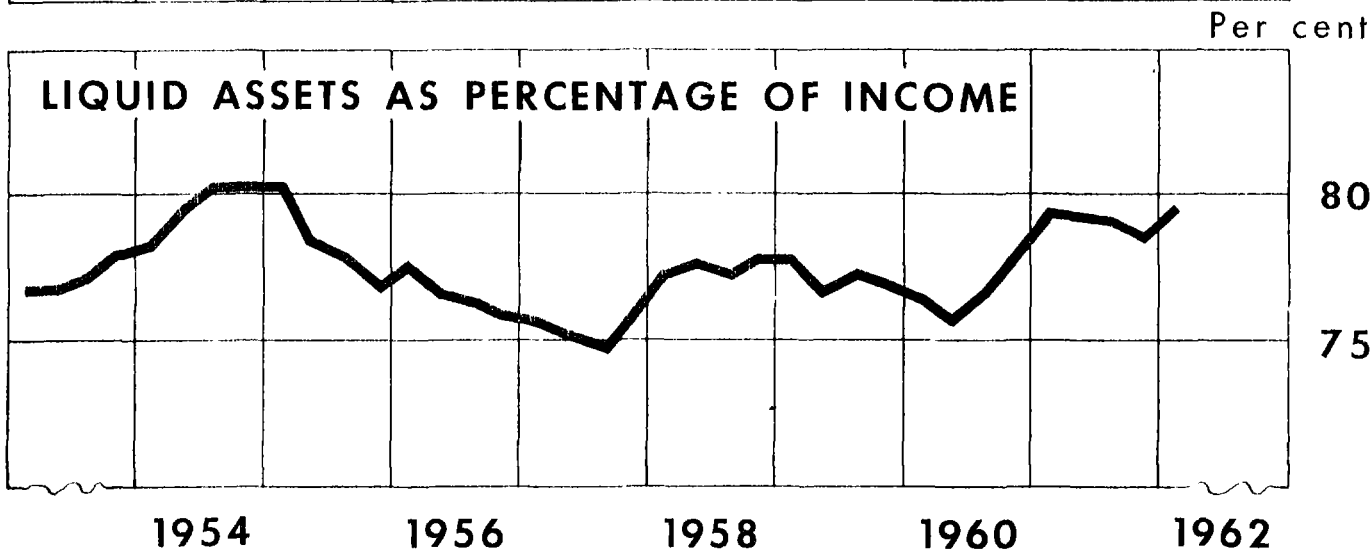
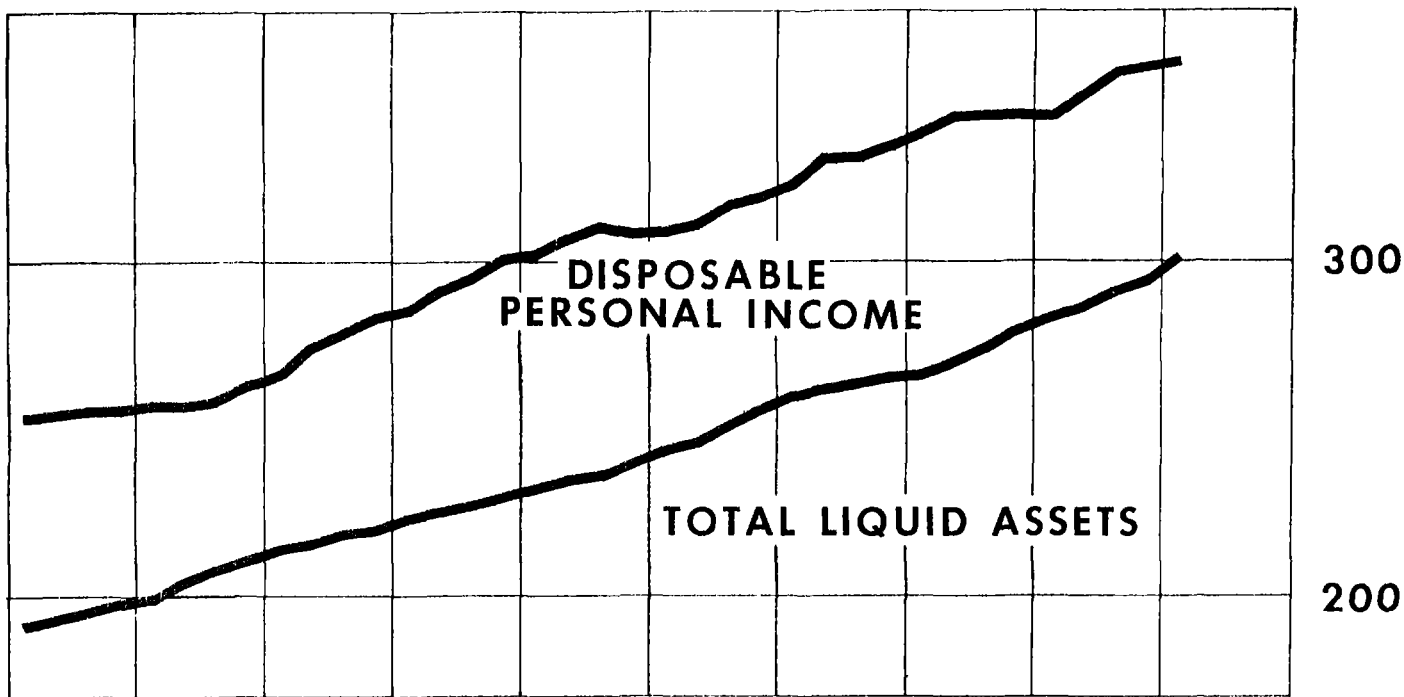


Chart 5

CORPORATE LIQUIDITY

Billions of dollars

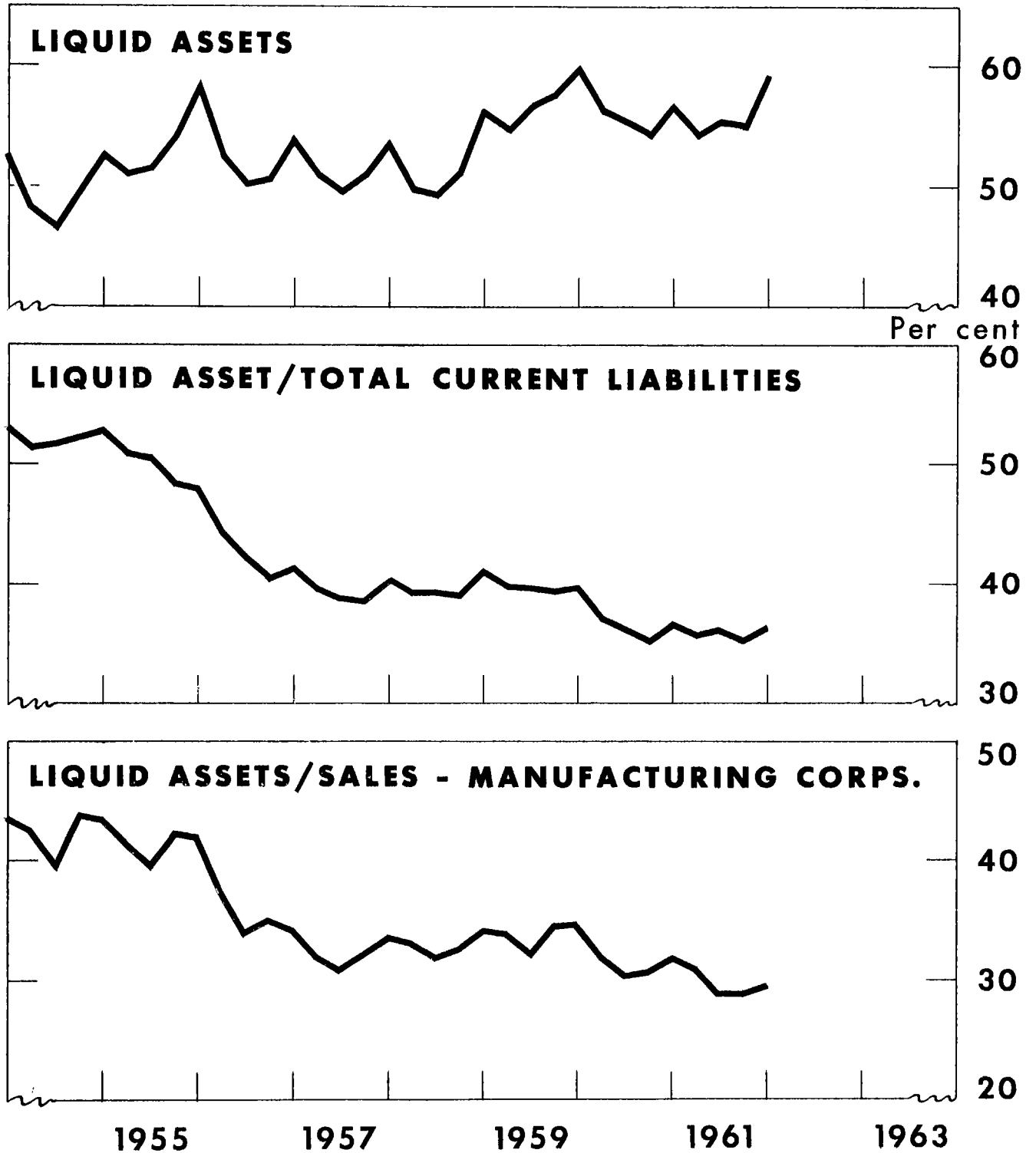


Chart 6

LIQUIDITY RATIOS COMMERCIAL BANKS

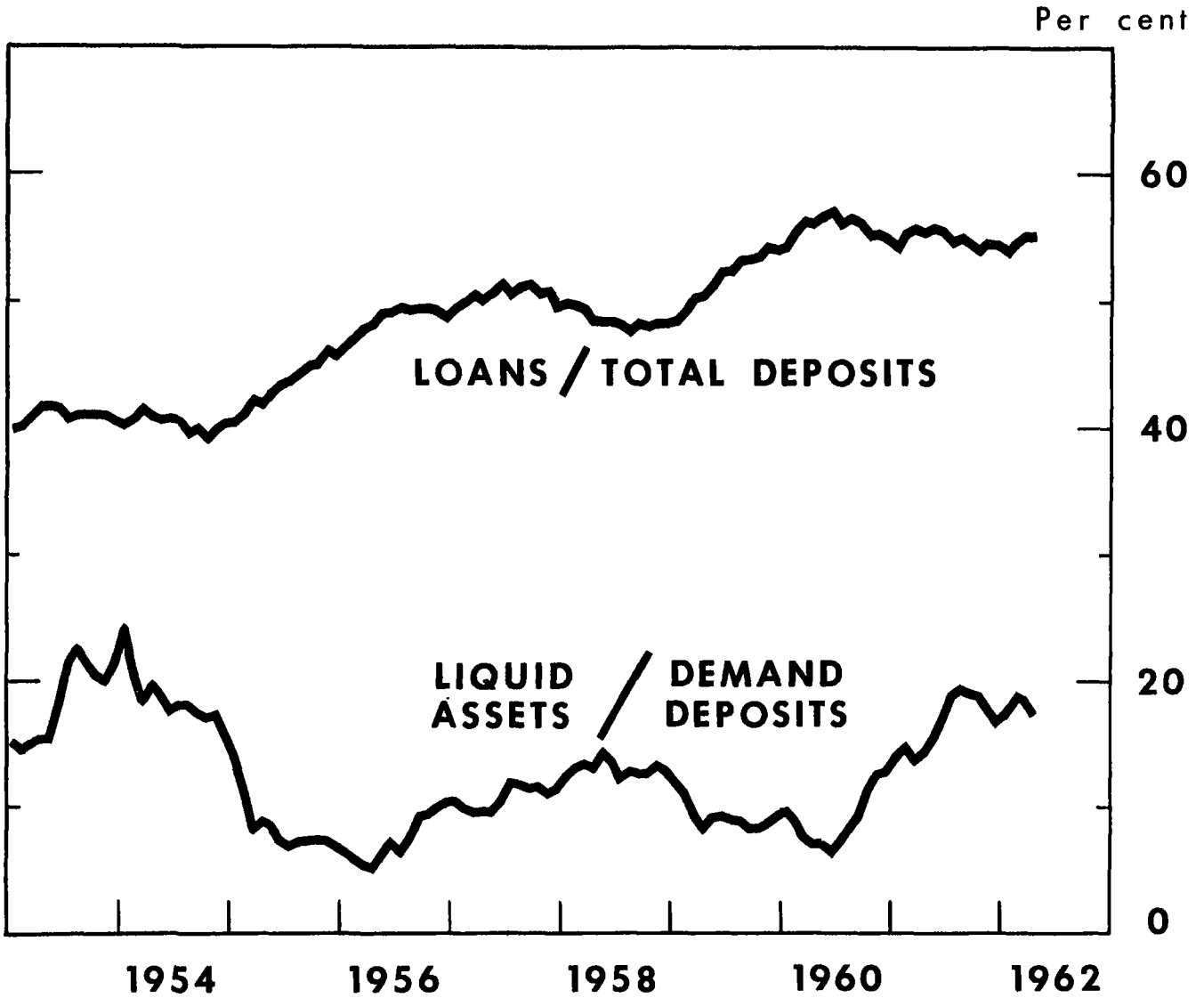


Chart 7

MONEY SUPPLY AND TIME DEPOSITS

Ratio scale
Billions of dollars

