For Release on Delivery

(Approximately 9:00 a.m.
Pacific Daylight Time
Monday, October 24, 1966)

Savings Flows And Public Policy

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Before the Annual Meeting of the Savings Division

American Bankers Association

San Francisco, California

on Monday, October 24, 1966

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> "The savings business during the past year has been one of discouragement. Vicious political attacks, popular hysteria, widespread unemployment and depreciation of security prices have tended not only to cause new deposits to lag, but also to make deep inroads in previous deposits. People could scarcely be expected to think clearly or to act with moderation in a period of such widespread stress and uncertainty."

Saying these particular words makes me very much aware of how little new there is under the sun, for these blunt words on the troubles afflicting the savings business were spoken from a similar podium almost exactly 33 years ago by my father, Gilbert L. Daane, when, as president of your Division, he addressed its annual meeting in Chicago on September 5, 1933.

Despite the ironic similarity of the complaints voiced by savings bankers in these two separate eras, however, in point of fact the underlying problems were markedly different. My father and his colleagues had to wrestle with the worst troubles of the Great Depression. In comparison, our problems today are chiefly those of prosperity--and if they are often just as trying technically, they involve only a fraction of the human misery. And for that we can all be deeply grateful.

The savings business, ancient though it is, has rarely been the focus of as much attention as it has received this past year or two. The basic reason is simple: savings are needed to finance investment, and right now investment demands are intense, probably too intense both in the United States and throughout the world. The public's demands for goods have burgeoned, bolstered by expanding populations and rising levels of income. Technological advances are exploding across the business scene, stimulating new wants and creating new methods to meet them. Governments, too, are eager to add to social capital, in the form of such long-term investments as schools, water and power facilities, highways and housing. All these uses have one thing in common: savings are needed to finance them.

In marshaling savings to meet these demands, the United States is often the envy of the rest of the world. Why? Not because we save a greater share of each income dollar than others; a good many European and Asian countries can boast a greater savings <u>rate</u> than we do. Not just because it is easier for Americans, with their more affluent incomes, to give up a little more marginal current consumption for larger future returns. Surely it is partly because of the sheer dollar size of America's savings potential, which allows much more room for saving and investment decisions to work themselves out amicably.

But the most important comparative advantage we have in the savings business, I submit, consists of our financial assembly lines--the powerful array of financial intermediaries and service institutions dedicated to assembling, packaging, and marketing the nation's financial savings in the most efficient (and hence to them the most rewarding) way. Other countries cannot boast the great number and variety of financial intermediaries that dot our landscape. If the proliferation of intermediaries may occasionally seem to be a competitor's despair, or a regulator's nightmare, it also comes close to being a saver's paradise.

What does the economy gain in return? Recent studies by teams of international experts suggest that, in comparison with most other countries, the United States benefits from its heavy layer of financial intermediation in four major ways: (1) efficient mobilization of myriad pockets of small savings making them available to a wide range of borrowers; (2) flexibility in shifting the uses of such funds in conformity with changing investment demands, (3) stabilization of important portions of savings flows through long-term contractual relationships; and (4) a high rate of return to savers relative to the cost to borrowers of obtaining funds.

Some of these benefits accrue principally from the very size of U. S. savings flows; they represent, in some sense, the benefits from economies of scale. But to an important degree, these benefits stem from a wide range of governmental policies; policies designed to encourage savers' confidence in the stability of the value of their savings, policies designed to encourage the confidence of savers in the solvency of savings entrusted to financial institutions, and policies designed to foster competition among institutions--competition for both savings inflows and investment outlets. It is true, of course, that the U. S. is not alone in having governmental policies oriented to one or more of these objectives. But it is true, I believe, that we have pursued all of these policies more vigorously than most other countries, and have reaped the benefits in the form of a large, diversified, efficient and--generally--smoothly functioning financial structure that facilitates the financing of investment objectives.

While a whole range of policies is needed to achieve such a standard of financial performance, it seems to me none is more important than the policies designed to foster a high degree of flexibility in both savings forms and investment outlets. Flexibility is needed to permit prompt adaptation to the significant shifts in investment opportunities and saver desires that can be generated in a dynamic society. Flexibility in these respects, in turn, is most assuredly provided by a combination of minimal regulatory inhibitions, on the one hand, and a lively spirit of competition, on the other. What this comes down to, in effect, is placing the maximum practical reliance upon the workings of competitive market forces in order to encourage the kind of performance that we want from our financial system.

All this may sound rather trite to you--a pledge of allegiance to obvious virtues. But lest you think these virtues dull, let me remind those of you who were nodding perfunctorily as I recited these policy objectives that you were nodding approval to a set of guidelines that could comprehend, among other things: the ultimate removal, or conversion to a standby basis, of Regulation Q ceilings; greater interest rate fluctuations; broader lending powers not only for banks but also for mutual savings banks and savings and loan associations; more widespread bank chartering and branching; and probably a few more disappearances from the ranks of financial institutions, both by failure or takeover. Do the principles I have cited still sound dull? And are you still sure you agree with them?

I would urge that we not shrink from the general thrust of these principles, viewed broadly and over the longer run as "guides to navigation" for the policy maker, so to speak. At the same time, realism forces us to recognize that today's world is not perfect, and that oftentimes problems or excesses can arise that threaten sufficiently harmful effects to warrant remedies or restraints being imposed either by law or regulation. What is important, in these instances, is to try to deal effectively with such problems and imperfections in ways congenial to an evolution toward the long-range market objectives that I have cited.

Examples of the kinds of problems that I have in mind--and of the kind of orientation I would advocate in dealing with them--can be found in abundance in recent savings experience. Let me call your attention to three particularly crucial examples to illustrate the point I am trying to make.

Certainly the savings problem that had the lion's share of the headlines in 1966 was the so-called "rate war" among savings intermediaries. I feel sure that no bank represented in this meeting has gone unaffected by the marked increases in interest rates available to savers. The basic cause for this intense rate competition, it should be remembered, was the extraordinary strength of credit demands generated by our overheating economy. These swelling demands for funds served to bid up interest rates very substantially in all sectors of the credit market, and the resulting attraction of savers' and investors' funds into higher yielding bonds and other market instruments served to slow up very sharply the flow of new financial savings into depositary institutions.

At the same time, loan demands from the customers of these same institutions were growing stronger and stronger. In these circumstances, all depositary institutions tended to raise rates of return to savers to try to maintain their net new inflows--but only commercial banks as a group were particularly successful in this respect. In contrast to their behavior in past postwar periods of strong credit demand, banks this time were both more willing to bid for time money--and also more able to do so--by reason of the greater leeway provided in Regulation Q ceilings on time deposit rates. Furthermore, many banks could hold down the cost of such strong bidding for time accounts by offering the highest rates only on CDs or other special instruments sold primarily to the margin of most interest-sensitive customers.

Other depositary institutions were simply not able to keep pace with commercial bank activities in this area. Why? Not because they were any less interested in meeting customer loan demands, but chiefly because they were not as flexible as banks in the interest rates attaching to either the assets or the liabilities in their balance sheets.

Mutual savings institutions of all types, wedded to the idea of making all interest and dividend rate increases applicable across-the-board, while holding earning assets that take a good many years to turn over at new rate levels, are exposed to much more serious earnings squeezes than banks when interest rates rise sharply. These facts were painfully obvious to managements of many mutual savings institutions this year, and also to the responsible regulatory authorities, and led to important restraints on the aggressiveness with which such institutions raised their rates proffered to savers in an endeavor to keep and attract loanable funds.

The consequences, however, were sharp shrinkages in new savings inflows to these institutions, and resulting drastic cutbacks in new lending to their chief customer, the housing market. While some cutback in housing, as well as other key sectors of demand, was implicit in a tightening of monetary policy, the housing industry was hit especially hard by the impact of such cutbacks, coming as they did on top of a major shift of new commitments by insurance companies away from mortgages in favor of corporate bonds.

These circumstances were, therefore, generating severe distress in the housing field. Some public remedial action was called for--but what should be its design? Some spokesmen, aiming at the symptoms rather than the cause of the troubles, favored regulatory roll-back of interest rates to the substantially lower levels that had been appropriate for a less strained economy. But such a course would have flown in the face of market forces. Rolling back the maximum rates for some or all depositary institutions alone would have accelerated the movement of funds away from these institutional outlets toward more attractively priced market instruments--and any effort to roll back all rates, in the market and at depositaries alike, would have accommodated still greater credit-financed spending that would have aggravated basic inflationary pressures.

Instead of engaging in such self-defeating actions, the authorities tried to move carefully, in a variety of ways, to moderate the situation and achieve a more orderly adjustment. The Federal Reserve, for its part, raised reserve requirements on time deposits to add a marginal cost and reserve restraint on bank issuance of CDs, and amended Regulation Q several times to hold down permissible rates payable by commercial banks on those kinds of time deposits most directly competitive with mutual savings institutions. Rollbacks of existing offering rates were held to a minimum. The aim was rather to prevent further competitive rate escalation, looking over the longer run to gradual development of the ability among savings institutions to set more flexible and competitively viable interest rates, thereby fostering less unstable shifts in savings flows and fewer instances of a sort of "now-you-see-it, now-you-don't" credit availability. The evolution of institutions toward positions of greater flexibility will represent a fundamental adaptation to market forces that will make Regulation Q itself less necessary as anything other than a standby control. This is precisely the kind of evolution I would hope for over time.

A second major credit problem this year grew out of something that the banks were doing too well; namely, taking care of their good business customers. Business spending intentions became very strong during 1966, as ebullient market prospects made new capital investment projects attractive and possibilities of price increases and shortages whetted corporate appetites for inventories. Business cash inflows fell far short of enough to finance outlays, particularly after the acceleration of Federal tax payments by corporations began to take effect. In these circumstances, and with bond market rates near historic highs, businesses turned heavily to their most dependable short-term source of funds, the banking system. Such demand for accommodation drew force from the years of good customer relationships that could be cited by many firms, and, more subtly, from the posture of eager solicitation of attractive business customers that had become almost a way of life for the current generation of bank lending officers. In truth, most banks were already sufficiently loaned up by early 1966, so that they were not delighted to have much further loan expansion thrust upon them. But the tradition of good customer relationships made it hard to say "No" to such requests; and the pricing conventions of uniform prime rate and compensating balance requirements proved too inflexible to be used to deter much loan demand. Thus, the banking system, tied to the customer conventions that had grown out of decades of generally easy money, found its own efforts insufficient and itself short of tools to deal with an undesirably large bulge of loan demands.

The consequences were unhappy, from several points of view. Bank loans to business rose sharply as 1966 progressed, financing bulges in business spending that not only were unsustainably large but also had the effect of sharpening short-run pressures on prices in an environment already fraught with inflationary pressures because of rising Government spending. In trying to raise the funds to meet such loan increases, banks cut back drastically on other loans. They also began to dump holdings of State and local Government obligations, creating incipient disorderly conditions in a market in which their buying had in recent years been a mainstay. And they pushed even harder their efforts to raise more time deposit money, with the consequences that I have already mentioned for the housing market and other savings institutions.

Here, again, the results of so uneven a credit flow--an unevenness clearly reflecting the incidence of monetary policy being called upon to carry too much of the burden of restraint--were judged to be undesirable. To be more explicit, the possible immediate consequences in terms of damage to financial institutions and to financial and real estate markets began to clearly outweigh the longer-range disadvantages that might be expected to flow from some temporary remedial action that would seem to interfere with usual market processes. A critical decision, however, concerned the form that remedial policy action should take. It could have taken the form of a long list of approved purposes: purposes for which business loans could be made, and perhaps even purposes for which securities could be disposed of, or time deposit interest rates raised. But such an approach would have presumed to supersede private with public judgment in every such category of decision-making. It would shortly have become an administrative nightmare, and it would have risked the stultification of private decision-making capacity. To every man concerned for the workability of the market system, this course must be an anathema.

A far preferable avenue seemed to be that of public action to strengthen private allocative procedures at the "weakest link in the chain," so to speak, in the hope that over the longer run the private market processes would themselves develop sufficient strength to assume the burden. One example of such public assistance was the special authorization voted this summer to permit special additional purchases of home mortgages by FNMA to relieve the worst of the pinch in the secondary mortgage market. Ideally, such FNMA operations would serve as a conduit temporarily siphoning an extra volume of funds from the central money market in which FNMA money is raised to the mortgage lending institutions hardest hit by adverse shifts of savings funds. In time, such institutions ought to be expected to re-achieve the kind of balance in flows of funds and interest rates earned and offered that will enable them to reassume their roles as active mortgage lenders.

Another action aimed at strengthening a "weak link in the chain" was the Federal Reserve letter of September 1 to all member banks, urging them to moderate loan expansion, and particularly business loan expansion, in the national interest in the stability of financial markets and sustainable, noninflationary economic growth. That letter stressed the relative desirability of banks adjusting their positions through loan curtailment but recognized that curtailing loans could well take longer to accomplish than the alternative adjustment route of liquidating securities and might necessitate a longer period of discount accommodation. At the same time the letter also made clear that the discount facility remained available as in the past to help banks meet seasonal or unusual needs for funds in accordance with Regulation A.

This letter was very careful <u>not</u> to say to whom a bank should lend, nor for what purposes, nor for how much, nor for how long. It was aimed rather at giving banks additional impetus for curtailing a larger fraction of business loan demand, leaving to the banks themselves the choice of means as to how to accomplish such greater restraint. If, out of this experience, banks develop the wherewithal to moderate changes in their own business loan total in the future more effectively, then the next period of monetary restraint should entail no resort to a counterpart of the September 1 letter. Market processes will once again have reasserted themselves, with sufficient force to keep credit flows reasonably balanced.

There is one more arena of savings activity from which I would like to draw an example for our consideration. I am thinking of the great flows of financial savings across national boundaries; in a variety of forms which together make up the capital account in a country's balance of payments. For some years, the United States has been a large exporter of long-term capital. A number of causative factors have been at work, but most important are the tendencies for American rates of return on long-term debt and equity to be lower than abroad, and the comparative skill and adaptability of the large U. S. capital market institutions in handling long-term financing, foreign as well as domestic. Many consequences that are socially desirable in the long run result from the large U. S. long-term capital outflows, but two shorter-run consequences have proved particularly troublesome: (1) their contribution to the persistent U. S. balance of payments deficit, and (2) an aggravation of foreign concern over the greater and greater role played by American commercial and financial interest in the economic life of other countries. Of these two problems, the first is essentially economic, and the other more political; the first is a tangible problem, the second somewhat more nebulous. Yet both problems have become of such dimensions that the U. S. has had to take them into account, and to devise policy measures to alleviate them.

A great deal of advice has been advanced as to how to handle these problems. One idea advanced is that of rationing long-term capital outflows by instituting a "capital issues" committee, of the European type, to control which long-run capital transactions take place. Others have advocated temporary or partial capital embargoes, as a swift and effective means of bringing capital outflows under control. I have no doubt that one or another of such devices could be made to work for a time, but my reservations are deep and abiding that such actions eventually deny the role that market forces should fill, and can most effectively fill, in the allocation of capital resources.

I am gratified that we moved in none of these directions when the pressures of these problems became overriding, but instead chose to introduce an interest equilization tax (IET) program to moderate our long-term capital outflow. The IET program is objective. By that I mean it makes use of the price system and the role of prices and costs in private decision-making. No approval or disapproval of individual transactions is involved. The program's purpose is clear; its effects are reasonably calculable, and it can be changed or dropped when the evidence suggests that market forces of themselves will produce a satisfactory equilibrium.

I could give other examples from both our domestic and international economic experiences but I am sure I have to say no more to persuade you that I am a firm believer in the long-run efficacy of the market process. I am sure most of you are also. My reasons for this belief are many and varied, as I judge so are yours. Some go well beyond economics, into the area of harmony with political democracy and a philosophy of personal worth and responsibility. But I suspect that for many purposes the most persuasive reason is the most pragmatic one: it works. Year in and year out, wartime aside, I submit that the market system hangs up a better record than any other. To be sure, it has its areas of inadequacy, where we like to provide an overlay of justice or the milk of human kindness. It has its failures in economic decision-making, but I would argue they tend to be smaller than under authoritarian systems (perhaps related to the fact that a man can be more stubborn when he's wrong than a market!)

Because I am convinced that markets have this long-run efficacy, I am equally convinced that, whenever circumstances may compel interference with a market, for any of a variety of reasons, that interference is best designed when it complements the market, rather than replacing it; when it employs market decision-makers insofar as feasible rather than dictating decisions to them. Best of all is the kind of market interference that fosters the development of market mechanisms that can eventually replace it completely. That I take as the surest proof that a public policy has served the public interest.

Having said that, I would hasten to add to this paean of praise for the market process that we should not, and cannot, call upon it to exceed its own capacities, particularly when we are in a war. Thus whenever forced transfer of savings is required for our national objectives, I think it can be best, and certainly most equitably, achieved through a coordinated use of the tax system alongside of monetary policy rather than through disproportionate reliance on monetary policy and the consequential allocative process in terms of price and availability of money. Make no mistake about it: the extraordinarily high interest rate levels, and the distortion in rate relationships, requiring recent public policy entrance into the allocative mechanism, reflected the inadequacy of fiscal restraint. That is why I for one favored a moderate tax increase across the board early in 1966 and feel that the issue remains open in view of the uncertainty about the acceleration of our effort in Vietnam.

More than filial loyalty thus prompts me to return to my father's remarks of more than thirty years ago, and to the peroration of those remarks:

> "Hope of better days lies ahead for bankers in the savings business. Savings are the great bulwark against the spectre of unemployment, old age and dependency. Pride, a sturdy virtue, sustains the practice of saving through banks. When again prosperity dwells among us savings undoubtedly will resume their high place."

Over the past thirty years this exalted view of the role of savings has been buffeted by the Keynesian revolution and the recognition that savings do not always constitute an unmitigated blessing in an advanced economy. But analysts (and perhaps even bankers) sometimes forget that Keynes as a practical man consistently fused his economic analysis with the then existing milieu--a milieu translated by my old friend and mentor Alvin Hansen as one of secular stagnation. But as was clearly pointed out in the recent biography titled "The Age of Keynes," Keynes himself "eloquently sketched the benefit of high saving" in a period when "capital was scarce, saving vital to economic expansion, and employment full." And in an economy at war, or tinged with war, his own analysis brought him not only to extol voluntary savings but even forced savings not via inflation but through required deferment of consumption.

In an economic milieu at times more fairly characterized as one of secular inflation rather than semi-stagnation, Keynes undoubtedly would have been in the forefront of those calling for adequate fiscal restraint to avoid cyclical aggravation and might even have been found leading us down the road to thrift, his arch enemy of thirty years ago.

But the real lesson to be drawn from Keynes, I believe, goes even deeper for it lies in his fundamental approach to problems--an approach rooted in rationality and lucidity and an approach which has real significance for you as savings bankers as well as for policy-makers. In Keynes' own words, "The next step forward must come not from political agitation or premature experiments but from thought." My father's presidential address in 1933 was titled "A Year of Change" and 1933 was indeed that for the saver and the savings industry! But so was 1966 and I can assure you that we in the Federal Reserve, as I am sure is the case with all of you in the savings industry, are re-thinking our problems and potentials most carefully as we try in these difficult times to meet the needs of monetary policy in a market economy.