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THE OUTLOOK FOR MUTUAL SAVINGS BANKING

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

81st Annual Convention
Savings Banks Association of New York State

Boca Raton Hotel and Club

Boca Raton, Florida

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It is a pleasure to address your 81st Annual Convention on a subject that is bound to be close to the heart of every American: the future of savings, and of the institutions that promote it. Never have we heard more about the urgent need for funds to finance all kinds of high-priority purposes, from the provision of housing to the generation of energy, from the creation of jobs to the conservation of the environment. The immense resources for these investments must be provided by saving. Yet never have the men and women called upon to provide these savings, who look to them as a means of protecting their future, been so doubtful whether saving is any longer worthwhile. I am sure it is, but there is much to do before that can be convincingly demonstrated.

There lies before us, arising from inflation, a series of difficulties that will culminate in national economic disaster if we do not act to correct the inflationary bias that is now distorting the economy.

First is the fact that inflation is robbing us of the buying power of our savings. But the damage inflation is wreaking on us goes far beyond robbery of our savings accounts.

Beyond that lies the fact that inflation induces exorbitant interest rates, and, by diminishing the flow of savings to thrift institutions, deprives borrowers of access to credit.

And, these factors have placed our thrift institutions, especially mutual savings banks, at the center of forces that are disruptive. Under the lash of inflation that is both long-continued and steadily intensified, thrift institutions are finding it increasingly difficult to perform their functions of collecting savings and channeling them to useful investment.

Moreover, thrift institutions are suffering pressures on their liquidity and earnings that test their viability.

Finally, the inflation that is hobbling our savings institutions, crippling them in their ability to finance new home building, can have important delayed effects, because a long-deferred revival of home building is bound to be a key factor in postponing general economic recovery next year.

The gloominess of these tidings -- and they are no more gloomy than need be -- emphasizes the need to pursue steadfastly the beginning that has been made on overcoming the current super-inflation. If we do not falter, we can succeed. But even so, considerable time will elapse in returning to reasonable price stability.

Nevertheless, one can see some signs that success is ours for the earning. At present, mutual savings banks are experiencing some of the early benefits of the anti-inflation effort made thus far. Savings flows, which for some time had been negative under the pressure of disintermediation, are turning positive again. Pressures upon the liquidity of the institutions are diminishing. If this trend is allowed to work itself out without interruption, the liquidity problem, for the most part, is probably behind us.

Other problems remain. One of them is the quality of assets. It remains to be seen whether all the commitments of funds that were made in an environment of euphoria and expansion will turn out to be sound. The economy faces a period of slack. During it, the underlying quality of assets is likely to be tested. Inflation, to be sure, often provides a protective cushion in terms of the underlying collateral by raising the replacement cost of assets. But that does not mean that the price of homes, of apartment buildings, of productive facilities must necessarily rise in the short run. Nor does ability to service debt necessarily rise during inflation. The distorting powers of inflation, in fact, have been so severe that the price of many assets has declined while the cost of living has been going up. In the field of housing especially, the early stages of inflation have seen overexpansion and overbuilding. The problems confronted by housing and construction generally are by no means all rooted in difficulties of financing. These difficulties exist, to be sure, but fundamentally we also have a problem of matching supply with demand. To the extent that supply of shelter has outrun demand, a period of under-building will be needed.

Concern with the users of funds -- those who borrow for home ownership or business purposes -- is appropriate. But at least as important is the fate of the suppliers of funds -- the vast number of Americans who save modest amounts out of modest incomes and who, by doing so over many years, often have managed to accumulate a substantial nest egg. Small savers have been among the principal victims of inflation. Squeezed between the limited interest rates that thrift institutions can pay and a rate of inflation that far exceeds these rates, they have suffered annual losses of many billions of dollars.

The loss of savings for most people is in most cases less immediately or personally injurious than the loss of a job. Nevertheless, in terms of dollars, it is probably fair to say that in recent years the losses of savers from inflation have far exceeded income losses from above-normal unemployment. Investors other than savings bank depositors, too, have suffered. Holders of common stock indeed have suffered a great deal. But they made their investments knowing that they were taking a risk. They have a chance, moreover, that their money may come back. There is little such hope for savings bank depositors, in terms of the real value of their savings.

Mutual savings banks were established to provide people of modest means with an incentive and a safe way of accumulating a provision for their future. Inflation has come close to destroying this essential social function. It is a tragedy for a nation when there no longer exists a riskless way to provide for the future.

If the foregoing has the sound of an indictment, that is because I regard inflation as a fraud upon savers, upon borrowers, and upon the soundness of the economy over-all.

By far the best way of playing square with the saver is to put an end to inflation. This must remain our objective. And in trying to bring down inflation we should be under no delusion that we can do without the traditional instruments of monetary and fiscal restraint, applied in such doses as the level of economic activity warrants.

The hope that other devices, be they called incomes policy, wage and price controls, or selective credit allocation, can absolve us from the need to limit the expansion of money, credit and government spending is fallacious. If such devices were to be employed as a screen behind which to practice an expansionary monetary and fiscal policy, the results will simply be excessive money creation, and excessive money, in the end, always means higher prices.

But inflation unfortunately will not be stopped overnight. Therefore, measures are needed to adjust to inflationary conditions while they last. Moreover, even after they have been defeated, these forces may revive. Therefore, painful as it may be, we must so equip our financial institutions that they can survive and can properly service borrowers and lenders during periods of inflation as well as during periods of reasonable price stability which I hope and believe will be the norm. This is a far cry from recommending devices that would build inflation into the economy permanently, such as indexing. That would mean, not to cope with inflation, but to surrender to it. Yet there are many things that can be done, particularly in the financial sector, and that in part already have been done, to enable financial institutions to cope more effectively with inflation if and when it exists.

Many of the measures contained in the proposed Financial Institutions Act of 1973 serve this purpose, especially those designed to broaden and diversify the powers of thrift institutions. Let me note, briefly, two interlocking changes recommended in that Act. These are the gradual lifting of ceilings on interest rates that may be paid upon savings deposits, and authority for thrift institutions to diversify into types of loans more liquid than mortgages. I stress the gradual lifting of Regulation Q, subject to standby powers to reimpose it, because I believe that under conditions of high interest rates, low interest rate ceilings are particularly unfair to the small saver.

The variable-rate mortgage and the variable-rate deposit are two devices that frequently are cited as possible means of "inflation-proofing" thrift institutions. I have never shared the view, common some years ago when I first wrote about the subject, that a variable-rate mortgage simply would not work in the American financial environment, whatever its usefulness may have been abroad. Developments in the meantime, I would like to think, have not proved me altogether wrong. In fact, some of the thinking if not the action along these lines now has gone so far that I find myself more nearly inclined to utter some warnings.

We are all familiar with the many legal, institutional, and practical difficulties that stand in the way of broader acceptance of the variable rate mortgage principle. The fact is, nevertheless, that about 12 per cent of all home mortgages outstanding in 1970 are reported to have had some element of rate variability, even though it has rarely been applied. Meanwhile thought is being given to an extension of the rate variability principle to a point where the mortgage rate might be increased to a level such that the monthly payment would fall short even of the interest required. The excess then would be charged to the principal of the mortgage, which would rise instead of being amortized. In justification it is argued that in an inflation the value of the property tends to rise, so that the owner's equity may be rising even though his mortgage is increasing. Obviously this could be a very risky form of financing, even though it does seem to provide an answer to the familiar problem of the borrower who would like to cash in on the appreciating value of his property. By no means all properties appreciate with inflation, and for those that do not do so sufficiently, a variable rate that would raise the principal value could create negative equities. However, it is true, of course, that even under conditions of general price stability real estate values in some areas may deteriorate and so may put even a standard mortgage under water.

Another unorthodox line of approach has recently been discussed: the non-level (i.e., rising) monthly payment. The level monthly payment, with a gradually changing proportion of interest and amortization, has been one of the great inventions of housing finance. To question it seems to strike at the roots of one of the most tried and true financial principles that we know. Nevertheless, inflation could make it less than optimal. In a continuing inflation, a level monthly payment will constitute a diminishing fraction of the average homeowner's wage or salary income. One might point out that this would be true even in the absence of inflation, if the economy enjoys continued per capita growth or if the homeowner advances in his career. Inflation, however, may severely accelerate the decline in the homeowner's income share devoted to mortgage payments. Today, the advance in interest rates and in housing costs has sharply raised the share of its income that an American household must devote to a new monthly mortgage payment. A nonlevel premium mortgage could correct this situation, by reducing the early payments and increasing the later ones. More housing would become accessible to more people if such a procedure could be made bankable.

It needs to be noted, of course, that the variable payment mortgage involves the possibility of low equity positions and high risk during the early years of the contract. Even more important, to fix a rising scale of payments over the life of the mortgage runs the risk of building a firm expectation of future inflation into the financing. For the borrower, there is, to be sure, an "out" -- in the absence of a prepayment penalty, he can readily refinance. This would confront the lender with a heads-you-win, tails-I-lose proposition. However, the same is true in some degree of all fixed interest rate mortgages whose interest and other terms embody a fixed expectation of continuing inflation.

Coupling the variable-interest-rate mortgage with a variable-interest-rate deposit or certificate opens interesting perspectives for the intermediary. The risk of a variable-rate liability may become acceptable to the intermediary if the return on assets varies commensurately. The risk inherent in a high fixed-rate liability, which can never be fully hedged because the rate on the mortgage, even though nominally fixed, is in fact variable downwards through refinancing, is largely eliminated. The variable interest rate of mortgage and deposit (or certificate) would have to be tied to some well known market rate. The choice of such a rate would depend on the maturity of the deposit.

For short-term deposits, something like the Treasury bill rate might be appropriate; for longer term certificates, a government bond rate might be better.

An important condition of this type of financing, if it were feasible at all, would be to keep the volume of variable-rate mortgages and deposits in balance. The variable-rate deposit would have to be so structured as to avoid large switches out of existing types of deposits. Thrift institutions by now have considerable experience in gauging the reaction of depositors to various types of interest rate inducements and should be able to take care of this problem.

Finally, a more systematic maturity matching at fixed interest rates remains a possibility. This would reflect the principle upon which the mortgage banks of central Europe have been constructed. It tends to eliminate the risks of inflation and other sources of interest rate movements as far as the intermediary is concerned, and throws these rate risks upon the saver. Prepayment of the mortgage would nevertheless remain a possibility and a source of risk to the intermediary, as would difficulties of marketing new securities.

It is a depressing sign of the times that novel ideas such as those I have cited, all representing departures from traditional modes of financing, must be contemplated. The traditional model has many virtues. Let me point out one that is sometimes overlooked.

Borrowing short and lending long is profitable when short- and long-term interest rates stand in their usual although not universal, upward sloping relationships. In addition, however, this practice also performs a useful social function by virtue of maturity intermediation. Short-term funds usually are more plentiful than long-term funds relative to the demand for these funds -- that is a reason for the upward sloping interest rate structure. Thrift institutions, by borrowing short and lending long, help to even out this imbalance. Schemes that successfully match flexible-rate mortgages with flexible-rate deposits, or that match the maturity of fixed-rate mortgages and deposits, deprive intermediaries of this function. This is just one more way in which the inflation creates new costs and distortions.

Tax exemption of deposit interest is a different type of proposal that recently has made its appearance. Typically, proponents have argued their case in terms of providing an incentive for saving, and that is their weakness. I confess to great personal sympathy with any effort to indemnify the small saver for the inflation losses he has suffered. But I do not believe that tax exemption of interest, in effect a higher net interest rate, is a reliable way to increase saving. The volume of saving attracted to particular institutions offering these tax-exempt opportunities, to be sure, would increase. But in all probability the bulk of these savings would be drawn away from other uses, rather than resulting from a genuine increase in over-all saving through a reduction in consumption.

The reason why one need not expect a higher interest rate to increase people's willingness to save is easy to see. Saving is basically provision for the future. The interest rate is the price of this provision -- the higher the interest rate, the lower is the cost of saving a certain capital sum. The reaction of savers to a reduced cost of provision for the future cannot be predicted in the abstract, but only in the light of experience. We know that a drop in the price of bread would probably cause people to spend less money on bread than before. A drop in the price of filet mignon might cause them to spend more on filet mignon than before. The response of savers to a cut in the price of provision for the future -- the interest rate -- so far as empirical research has been able to determine, appears to be insignificant. A rise in the interest rate, in fact, seems neither to increase nor to reduce saving.

With all due sympathy to savers, it would be well for the economy if this were reliably so. Inflation has made the real return to saving negative. If saving were highly responsive to interest rates, inflation would have reduced saving severely, to the great detriment of the economy. Fortunately it does not seem to have done this so far, although savings in thrift institutions have diminished. But nobody can be sure that at very high rates of inflation people might not reduce saving and begin to try to beat inflation by buying ahead, leaving provision for their future to the powers that be.

On equity grounds, there is, of course, a very good case for compensating savers against inflation losses. But it would be neither wise nor fair to do this at the expense of the general taxpayer, as the tax exemption proposal suggests. It would not be wise because the loss of tax revenue would mean a bigger deficit and in the end more inflation. It would not be fair because the beneficiary from inflation, who has gained what the saver has lost, is not so much the general taxpayer as the borrower and homeowner.

Without ignoring in the least the many problems that inflation brings to the homeowner, it is nevertheless true that in terms of his net worth he comes out ahead. He is a debtor and he gains additionally if his property appreciates faster than the rate of inflation. If the saver is to be compensated for his inflation losses, it is probably the inflation gains of the debtor that we should look to. Interest rates that reflect inflation, variable or fixed, are the most obvious device to accomplish this objective with respect to mortgages and deposits. I fear that I have no good suggestions for recapturing, on behalf of the owner of existing savings deposits, any part of the inflation gains of debtors that have already accrued.

Earlier in my remarks I alluded to the liquidity pressures that many mutual savings banks had experienced during the summer and that in some cases may still prevail. This experience has made many savings bankers review their sources of liquidity and may have caused some of them to think of the possible advantages of membership in the

Federal Reserve System. Your National Association, I believe, is doing some research in this direction. I would like to close with a few remarks on this subject.

One of the principal advantages of Federal Reserve membership is access to the discount window on the least costly terms. In an emergency, such access can be made available also to nonmember financial institutions. However, there has historically been a substantial spread between the rates for members and nonmembers, and I see no assurance that in the future that spread will be unchanged. Federal Reserve membership has many other advantages, among them direct access to the Federal Reserve check clearing facilities and to the wire transfer system. If mutual savings banks are to move increasingly into the money transfer business, through acquisition of NOW accounts or of checking powers, these facilities would gain in value to them.

On the other side, there are the costs of membership, especially the cost of maintaining interest free reserve requirements. This cost may be mitigated in some degree by the fact that reserve accounts may also serve as clearing accounts for transfers through the Federal Reserve System. Moreover, the Federal Reserve Board recently announced a reduction in reserve requirements on certain longer term time deposits while also raising those on time deposits with an initial maturity of less than six months. Under this rule, institutions can arrange the maturities of their purchased deposits so as to economize on required reserves, reducing the cost of membership.

Nevertheless, it must be recognized that the cutback in earning assets that would be necessary in order to establish required reserves could react adversely on the supply of funds to the housing and to the bond market. Under these circumstances, significance attaches to the proposal for a minimum 1 per cent minimum reserve requirement against time and savings deposits that the Federal Reserve has suggested in proposed legislation sent to the Congress.

A 1 per cent requirement would be the bottom of a range running up to a possible 10 per cent, if this proposal -- as I hope -- were enacted. If the requirement on savings deposits were set substantially below the present minimum -- and actual -- 3 per cent requirement, the cost of Federal Reserve membership for mutual savings banks might come into a more affordable range. It would then balance better with the advantages of membership.

Other attractions for the saver would be the competitive use of new techniques by which savings deposits, insofar as permitted by law and regulation, can be utilized directly for the payments of obligations, as well as the employment of electronic funds transfer and other helpful technology in the gathering and disbursing of savings. Mutuals must also, I think, be alert to ways in which their primary product, the mortgage loan, can be made more advantageous both to the borrower and to the bank, such as the variable rate mortgage.

What, then, is the outlook for mutual savings banks?

For the short term, one can say that the worst of the recent liquidity squeeze may be behind us, and that savings flows have turned positive. Further, that beginnings have been made in coming to grips with inflation. Pursued with determination and courage, this effort can in time succeed. Nevertheless, further adjustments -- also rooted in inflation -- will be needed to bring housing supply created at a time of inflation-inspired euphoria into balance with demand.

The outlook depends to a considerable degree upon the success mutual banks have in devising attractions for the saver. The principal objective should be to pay him a decent interest rate. That would involve phasing out Regulation Q, with the safeguards that I have mentioned.

For the longer term, every effort must be bent to improve the position of the thrift industry. I have suggested a number of steps that I think would be helpful, among them institutional and regulatory reform and Federal Reserve membership for savings banks. Given the best of futures, there will always be periods of monetary restraint that will test the liquidity of savings banks. Thus, direct access to the Federal Reserve's discount window will always be a valuable escape hatch, for the fundamentally sound bank, from liquidity pressures.

But the only assurance of protection against the tragedy of losing the means of providing, through savings, for the future is to build an inflation-proof economy. We can only play square with the saver by putting an end to inflation, and we must recognize that there is no way to do this without adequate doses of restraint through the traditional instruments of monetary and fiscal policy. If thrift institutions cannot find ways of protecting the saver, they will lose him to other forms of providing for his future.

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