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Remarks of

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before the

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of the

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

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Within the past five years, the American economy has come close to realizing its long-sought goals of high employment, growth, and price stability. The unemployment rate has declined sharply. The annual increase in the aggregate national product has surpassed the most optimistic predictions. And, until about a year ago, consumer and wholesale prices remained relatively stable. Most forecasts of the economy for 1967 predict continued expansion, but at a slower rate than this year -- and foresee the possibility of greater price stability.

Our economic progress, however, has not been without its problems. As prices began to rise, the Federal Reserve attempted to restrict the availability of credit. This action, in conjunction with heavy demand for credit, pushed market rates of interest to the highest levels since the 1920's. But the speed with which interest rates rose produced competitive maladjustments, especially in the market for savings. To cope with the resultant imbalances, Congress gave the Federal supervisory agencies more flexible authority to change interest rate ceilings. As a consequence, a rollback of maximum rates payable by commercial banks on "consumer-type" savings and time accounts and the introduction of ceiling rates for savings and loan associations and mutual savings banks were announced last September.

The intense competition for funds and the uneven impact of high interest rates on the economy generated some heated discussions of the function of interest rates in our economy. It might therefore be useful to review very briefly the nature and function of interest and its role in our economy.

Employment of funds in a productive enterprise might be used as an illustration. As commonly used, "interest" refers to the amount of money paid or received for the use of a sum of money -- called the principal. The borrower contracts to pay to the supplier of the funds an amount over and above the principal because he expects to put the principal fund to work to produce earnings more than sufficient to cover the cost of the money to him plus repayment of the principal. At times, borrowers overestimate their abilities as entrepreneurs, and the sum actually earned fails to cover the interest due or the principal, or both. The venture is unsuccessful. But this is how our private, free-enterprise, profit-and-loss system operates.

Apart from the borrower's own entrepreneurial skills, his ability to pay interest is primarily determined by the productivity of real capital -- that is, the capacity of capital goods or consumer goods financed with the funds made available to produce more in value than their own purchase price and operating expenses. The productivity of capital, in turn, stems from the ability of the goods or services produced to satisfy the desires of final purchasers -- whether consumers, governments, or business firms. The higher the productivity of capital, the greater the amount of interest its owner is willing and able to pay.

Those able to compete effectively are thus enabled to acquire more capital. In this manner, the available savings of the economy are allocated to the most productive and efficient uses. In the real world of industry and finance, of course, the process is far more complicated than the simplified version presented here.

In our dynamic economy, the basic relationship between borrowers and lenders can be easily hidden, primarily because the process has through intermediation assumed so many complex and varied forms. The simple transaction, for example, where the saver lends directly to the ultimate purchaser of capital goods has become infinitely varied and intermediated. In addition, commercial banks are able to satisfy some of the need for funds through the workings of the fractional reserve system.

Financial institutions intervene to collect relatively small amounts from countless individual savers, pool these resources, and lend in considerably larger amounts to various borrowers. In addition, they are able to offer maturities suited to the requirements of the individual saver by accepting funds at short term or even on demand and then supplying funds for considerable longer periods. For these services, intermediaries charge higher rates of interest than they themselves pay. Nevertheless, there can be little question that the borrowing and lending process is performed much more efficiently with intermediation than if it were carried out directly by the individual saver or borrower.

Intermediation tends to obscure the price function of interest rates as a device to ration real capital goods, but it is a vital and necessary economic service. As a result of intermediation, interest appears to arise from the process of intermediation itself, rather than from the complex interaction of many other factors.

The simultaneous existence of many interest rates -- each rate apparently pricing a different bundle of money under varying conditions -- also obscures the connection between interest rates and capital. Money and capital markets are to some extent compartmentalized and thus insulated in some degree from competition with each other. Geographic barriers, imperfect knowledge of market conditions, differentiation of repayment terms, and the availability of alternative maturities create rigidities in the financial markets and explain the existence of a multitude of interest rates.

But compartmentalization of money and capital markets is neither permanent, stable, nor complete. All interest rates tend generally to move together as lenders or borrowers have the option to choose among alternatives in response to changes in their evaluation of the quality or terms on debt instruments or in the economic outlook. Over time, yields on debt instruments similar in risk and terms tend to be the same under the free interplay of market forces.

From World War II until the Treasury-Federal Reserve accord of the early 1950's, interest rates did not accurately reflect market forces. Following the accord, interest rates fluctuated in response to supply and demand forces within a framework of broad control by the Federal Reserve over the total money supply. And, until recently, the ceiling rates on commercial bank time deposits were for the most part not restrictive. Rates on time money were generally higher than prevailing rates on other marketable debt instruments.

Currently, however, the ceiling rates on many of these accounts are somewhat lower than the yields obtainable on many other competing investments. This type of competitive situation restricts the ability of financial supervisory agencies to encourage a further lowering of the rate structure for time deposits through administrative action. Administrative action, however, can help to check escalation in interest rates paid by financial intermediaries in the competition for savings. A less rapid rise in interest rates provides financial intermediaries with more time to adjust their assets and operations to the new and higher market structure of interest rates prevailing today.

It should be clear from what has been said that regulatory authorities cannot effectively fix the maximum rates of interest paid on deposit-type accounts without reference to the rates prevailing in the market and to the productivity of real capital. Unrealistic ceilings encourage savers to short-circuit the savings-investment process by bypassing the financial intermediaries and lending directly in the money and bond markets. To prevent such disintermediation, it would be necessary to control somehow the whole structure of interest rates. But centralized control of rates in peacetime is wholly alien to our economic system. It would conflict with the principles of our private enterprise economy and force the authorities to allocate savings among competing uses by administrative action.

The regulatory authorities should not be expected to set rates for the financial institutions under their supervision. If our economic system is to work efficiently, the rates offered by financial intermediaries to savers must be determined by the institutions themselves. This determination is the prerogative and responsibility of management. The ceiling rates established by the regulatory agencies must not be construed as suggested rates, moreover. The ceiling rates are chosen to permit most institutions sufficient leeway within which to exercise their own judgment concerning the rates appropriate to their own situation -- and yet consistent with the public interest. The decision and responsibility are yours. Our role necessarily must be confined to assisting financial institutions during transition periods to adjust to new situations so that they are better able to serve the public efficiently and effectively.

In the past two months, there has been some easing of upward pressures on rates in the money and capital markets. The differential between rates available on marketable instruments and the rates paid by financial intermediaries on deposit and share accounts has narrowed. The dampening of competitive pressures should provide a welcome respite -- however temporary -- to carry out some of the adjustments needed to adapt to the recent changes in the savings market.

The current competitive situation in the market for savings does not indicate a need for any additional regulatory action affecting the interest rate ceilings applicable to mutual savings banks at this time. The maximum rates permitted mutual savings banks appear to allow the degree of discretion necessary for an individual institution to set rates in light of market conditions and yet retain the flexibility essential to profitable operations. We are keeping in touch with the overall situation. If necessary, we are prepared to take further action to prevent a recurrence of the disruptive conditions of a few months ago or to deal with any problems stemming from regulatory actions.

The mutual savings industry should take advantage of whatever breathing spell it has to redouble its efforts to increase its operating efficiency and to explore possible new portfolio opportunities and methods to attract and hold savings.

The commercial banks have adjusted to the current competitive conditions by offering the public tailor-made debt instruments, with an attractive array of terms and conditions from which the public could pick precisely the maturity and liquidity desired. A broader range of services have also been developed to attract customers.

The thrift institutions have found it somewhat more difficult to adjust quickly to the new competitive situation. Mutual savings banks -- like other thrift institutions -- are being progressively squeezed between the current high rates of interest paid on deposits and the relatively low average rates of return on their investment portfolio, most of which was acquired prior to the rapid increase in market rates. Unlike capital borrowings or the sale of certificates of deposit by commercial banks, deposits at most mutual savings banks share in any increase in rates; the higher rate is generally not paid on just the new deposits. Yet, savings acquired in the past were invested in low-yield assets.

Mutual savings bank portfolios, moreover, are no longer as liquid as before because of the scarcity of funds -- an experience shared of course by all financial intermediaries. Assets cannot be easily liquidated or shifted, and the "purchase of liquidity" is not readily available. But your investment alternatives are somewhat broader than those of other thrift institutions, although the inability to divest yourselves of lower yielding assets effectively precludes your taking advantage of the attractive terms of many offerings today. Unless these limitations are overcome, portfolio earnings will continue to be depressed.

Thrift institutions also encounter limitations on their freedom to determine dividend rates. The basic constraint is imposed by the market. In the short run, in order to retain deposits, it may be less expensive to increase dividends than liquidate assests as a means of checking or forestalling disruptive deposit outflows. A strong capital and surplus position would help to accommodate such short-term adaptations to market conditions. On the other hand, a policy of increasing dividends merely because the competition is doing so is highly doubtful.

Continuation of the current strong competition for savings and investment -- and its possible intensification -- poses a challenge to mutual savings banks to develop new and creative ideas. New computer methods of processing masses of data can be successfully applied to bank operations to reduce costs, to help management in its decision-making process, and to undertake marketing research. Use of this new management tool would enable mutual savings banks to compete more effectively.

There is another vital area in which the mutual savings bank industry could render a major service to society, to the local community and to its own long-run earnings and growth prospects. There still exist significant opportunities for promoting the savings habit and extending the services of mutual savings banks to those within your trade areas whose saving is low or even negative.

Helping the less affluent to save and to learn how to manage money has been the historic role of the mutual savings bank industry. It is a role of which you should be justly proud. Your industry has had longer and more valuable experience in this area than any other financial institution. And there is a genuine need for this kind of service today. It would be a particularly appropriate means of rededicating ourselves -- on the 150th anniversary of the founding of the first two savings banks in America -- to these high purposes.

In the early years of mutual savings banking, depositors were able to improve their economic position through your assistance. The problems created by the growing concentration today of the nonsaver in urban areas could be alleviated through encouragement of habits of thrift and provision of competent financial advice. The initial cost may be sizable but the rewards -- both financially and to the community -- can be great. Once the financial status of this less affluent segment of our population improves, increasing use will be made of the facilities of the institution that helped them to climb out of poverty.

The events of the past year have focused attention on the savings market and the savings industry with an intensity probably never before experienced. We have been able to obtain a clearer insight into our problems and their possible solution. We have gained a better understanding of the current economic and financial environment -- and of its workings, its complexity and its opportunities. Attitudes have in the process been modified and updated, and positions transformed. It has been an interesting and challenging period of time.