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SAVING: AN OLD-FASHIONED VIRTUE

IN A NEW-FANGLED WORLD

Summary of Remarks by

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before the

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of the

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I am pleased to be able to join with you in this annual stockholders' meeting. In the past these meetings have often been the occasion for some reflection upon one or more of the important issues facing the banking system and the nation. I shall try to continue that precedent.

New England is the traditional home of some of the sturdiest virtues of our citizenry. It seems particularly appropriate, therefore, for me to be talking about one of those virtues today.

Saving is a characteristic that has stood Americans in good stead since the days of the Pilgrim Fathers. It has enabled families to build up some protection against the uncertainties of the future, and it has often financed a better life tomorrow.

Rarely, however, have savings-minded people faced as troublesome an economic outlook as we face today. Our economy is being ravaged by inflation, upsetting plans and clouding the future. Consumer prices have risen more

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than 12 per cent over the past year, and wholesale prices have risen even faster. The prices of such key items as petroleum and food have leaped upward. The devaluations of the dollar, poor grain harvests, and simultaneously rapid economic expansions in the major industrialized nations have all contributed to the raging inflationary pressures in our economy.

As a result of the inflation, the purchasing power of consumers' income and savings has been seriously eroded. The real value of savings deposits, pensions, and life insurance policies has declined. Even the reported rapid rise of business income turns out to be rather anemic when one takes account of how much less of ongoing business needs those inflated profit dollars will pay for.

Public spokesmen from President Ford on down have identified inflation as "Public Enemy Number One" of our economy. What is more gratifying is the apparent groundswell of public determination to do something about it. That feeling was manifest in the several summit and pre-summit conferences on inflation, and it has been reflected also in the first reactions to the President's program to quell inflation which he announced on Tuesday

afternoon. Those comments also made clear, of course, that there are disagreements as to the variety and stringency of public and private actions called for. One theme that has seemed to reappear often in public comments, however, is the need for somebody--be it the Federal Government, private business, or individual citizens--to save more.

It is in the nature of our competitive enterprise system that it tries to offer greater incentives for those economic actions it most needs. It should be no surprise, therefore, that even before the summit conference various financial institutions and markets were being extraordinarily creative in trying to attract savings. This stronghold of Yankee ingenuity gave us the NOW account. A few miles to the west, in New York, Citicorp produced a variable-rate note tailored for the more imaginative, middle-size saver. Some mutual funds are doing a land-office business in buying up high-yielding money market instruments and packaging them in ways that permit participation by the smaller saver.

Meanwhile, all around the country, financial markets and institutions are offering some of the highest

interest rates ever paid on traditional savings instruments in an endeavor to attract funds. To be sure, the top rates payable to savers by depository institutions are held down by bank regulations like the Federal Reserve's Regulation Q. But Regulation Q ceilings are not aimed primarily at keeping the small saver from receiving an equitable return. Rather, those ceilings--whether one favors them or not--ought to be recognized for what they are: an effort to protect the viability of the thrift institutions. The present asset-liability mix of these institutions limits what they can afford to pay for funds during periods of escalating interest rates.

Nonetheless, one hears talk these days that raising the rate of return paid on savings as much as feasible will help to fight inflation. High interest rates on savings are expected to encourage consumers to save more and spend less. While this may sound plausible, I must tell you that many of my economist friends are very skeptical of this conclusion. To a well-trained economist--and there are an impressive number of them here along the banks of the Charles--this kind of theory

lacks validity unless and until it is well supported by facts drawn from actual experience. And such persuasive proof, to date at least, does not exist.

Plenty of factual studies have been made of people's spending and saving behavior. It is easy to prove that sizable amounts of savings are attracted from one saving outlet to another when the latter offers higher interest. But studies of the effects of higher interest rates in increasing the total of all forms of personal saving combined are either unencouraging or ambiguous.

Typically, economists have tried to measure this behavior in reverse, that is, by testing whether changes in total consumption are affected by changes in interest rates. In two studies of this type in which an interest rate was used explicitly, one author found a positive relation between consumption and the rate of interest while the other author found a negative relation.^{1/} Perhaps out of respect for these unpromising findings, none (so far as I know) of the well-known

^{1/}C. Wright, "Some Evidence of the Interest Elasticity of Consumption," American Economic Review, September, 1967 and W. Weber, "The Effect of Interest Rates on Aggregate Consumption," American Economic Review, September, 1970.

econometric models being used today to forecast the short-run economic future allow for any direct effect of interest rates on total saving or consumption.^{2/}

What is the logic behind these conclusions? To the economist, the answer is simple. Both in theory and in proven fact, by far the most powerful influence on how much people spend is how much they make.^{3/} In other words, consumption is dependent upon income, present, recent, and/or anticipated; and that means the residual --saving--is also. By the time one allows as well for the leads and lags in consumption changes that can occur either as a matter of deliberate family choice or consumer inertia there is little or no systematic unexplained residual in saving patterns left to attribute to interest rate influences. Millions of American families, of course, are busy reacting in millions of different ways to their varying circumstances, but those differences so average out in the overall data that the imperfect

^{2/}There are models that provide for an indirect effect of interest rates on consumption through induced changes in the value of household wealth (e.g., holdings of securities).

^{3/}A. Ando and F. Modigliani, "The 'Life Cycle' Hypothesis of Saving: Aggregate Implications and Tests," American Economic Review, March 1963; J.S. Duesenberry, Income, Saving and the Theory of Consumer Behavior, 1949; M. Friedman, A Theory of the Consumption Function, 1957.

analytical tools of present-day economists cannot distinguish an average effect of interest rates on total personal spending and saving.

Furthermore, most families save at least in good part in order to pay for some anticipated future outlay. But to finance any given future expenditure, the higher the rate of interest earned by savings, the lower the total amount of principal that has to be saved. Thus, higher interest rates tend to offset some savings needs, unless prices rise or people's aspirations change in the interim--which admittedly they often do.

Is this another case of economists telling bankers and others that their common-sense instincts are wrong? Is it a mistake to try to promote savings by offering high rates of interest? Might we better order savers to be paid low interest rates, and save borrowers the burdens of high debt service cost? Do high interest rates serve no good purpose?

My answer to all of these questions is, "No." High interest rates serve useful functions in periods of inflation. First, they promote efficiency in the alloca-

tion of the available pool of savings among competing uses. Market-determined interest rates, high or low, are the best mechanism we have for allocating savings, so long as we intend to allow savers to put their money wherever they think best. The alternative of having regulators allocate credit directly is unlikely to be workable for very long.

Second, interest rates, if essentially market-determined, can serve the cause of equity. They reward savers for the relatively uncommon and valuable act of forbearance from buying in time of inflation, and they can also offset in part the eroding effects of inflation on accumulations of past saving.

Finally, I believe also that--notwithstanding everything I have said heretofore--interest rates that are high enough can probably coax some expansion of total saving out of the economic system. It is not that I regard the various factual studies of saving as wrong. I surmise they were focused on periods with interest rates and inflation rates much lower than at present, and

hence there was too little effect on aggregate saving to be detected by the measurement techniques used.^{4/}

It is worth remembering that two of the path-breaking theories of consumption behavior articulated in the years since World War II each provide for an influence of interest rates on consumption and saving.^{5/} Given the availability of today's superhigh levels of interest rates, and with inflation rapidly eroding the buying power of past savings, I find it reasonable to conceive that current saving is showing a positive response.^{6/}

If there is merit in this line of thinking, then 1974 and its surrounding years will prove a very fruitful period for retrospective analysis by students of interest rates and economic behavior. Key policy

^{4/}See, for example, Duesenberry, op. cit., p. 111.

^{5/}Friedman, Ando and Modigliani, op. cit. Without going into detail, both these explanations of consumption behavior essentially contend that individuals try to even out their consumption stream over their lifetimes even though their income streams may vary greatly during the same period. Interest rates are regarded as influential because individuals will need to borrow and lend in order to even out their consumption streams.

^{6/}In this connection, one consideration to which I would give an unconventional amount of weight is the aspirational effect of the return available on saving; that is, I believe earning a higher interest rate tends to increase a saver's aspirations for products that he can buy in the future with the proceeds of his saving.

decisions in the inflation fight, however, cannot wait for the reassuring results of such studies. Both public and private decision-makers are faced, as is so often the case, with the need to act now despite the handicap of insufficient knowledge.

There is one other economic finding, however, that can assist any inflation-fighter debating how much emphasis to place upon achieving even modest increases in total saving. Economists have long maintained that slim marginal changes in amounts supplied can have major market impact. When it comes to enlisting more saving in the battle against inflation, every little bit helps.