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Remarks by

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

at the

Midyear Meeting of the National Association of Mutual Savings Banks

New York City

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Once again in its long and, on the whole, very successful history, our country is going through a time of troubles. In the economic sphere, exorbitant inflation has become our main difficulty. Economic activity and employment still continue at very high levels. But a slowdown seems to be ahead. Such a slowdown would not be without its compensating advantages -- it should bring relief from rising prices and from pressure on the dollar. Of course we would have to do what we can to soften the impact on those most affected -- the people who lose jobs. With steadiness of purpose, standing firmly by our anti-inflationary policies, and with willingness to accept sacrifices that for a rich country like ours are modest, we can overcome our problems.

The Plight of Mutual Savings Banks

The mutual savings bank industry is experiencing more than its share of these national troubles. Mutual savings banks have weathered storms before and, I am confident, will weather this one. But each time around, there are new difficulties that need action and new responses.

One of the characteristics of the present period of financial stringency has been that for a considerable period housing on the whole was quite well sheltered against it. Unlike in past episodes, the impact of monetary policy was mainly on the thrift institutions and only to a lesser degree on housing. For the economy as a whole, this has been an obvious advantage, but it clearly presents great problems for the thrift institutions.

In the earlier phases of the present period of financial pressure, the savings bank industry had been less beset by disintermediation than on previous occasions of rising interest rates. For example, between June of last year and March of this year, total savings bank deposits grew at an estimated 7.3 percent seasonally adjusted annual rate. This compares with about a 2 percent growth rate in all of 1974. The principal reason for this greater ability to hold deposits was the money market certificate (MMC).

But this relative success has been achieved at the cost of a rapidly developing squeeze on earnings. Moreover, the change in MMC ceilings instituted earlier this year in order to reduce pressure on earnings has diminished the effectiveness of the instrument in sustaining flows at MSBs. The rate of return on assets, after deducting interest and other costs, dropped from .64 percent in the first half of 1978 to .52 percent in the first half of this year. Given the rates at which new MMCs are being sold, it probably fell considerably further in the second half of the year. Most mutual savings banks have the advantage of possessing a relatively strong surplus position, stronger in many cases than the corresponding capital/asset ratios of savings and loan associations. Their surplus position has been aided, moreover, by the slowing in the growth of deposits. It must be recognized, however, that on this occasion more than in the past there are wide differences among mutual savings banks located in different geographic areas.

The condition of the industry today reflects imbalances in our economy and our society that go far beyond the short-term aspects of the business cycle. We have the problem of low interest rates on old mortgages that the debtors are making every effort to keep in effect. This contrasts with the high rates that must be paid by savings banks on new money and also on money that would otherwise be withdrawn. We have the unfair treatment of the small saver who by law is prevented from receiving a market-oriented return on his savings, juxtaposed to the problem of the thrift institutions whose survival might be threatened if they had to pay the small saver a competitive rate. More fundamentally, we have in our society the conflict between homeowners who are obtaining large capital gains on their homes as a result of inflation, vis-a-vis the plight of the saver who is being expropriated by the same inflation, and vis-a-vis also the would-be buyer of a home who is forced out of the market by inflationary home prices and interest rates. Inflation is dragging this country into a kind of economic civil war.

Basically, there is only one answer. We must bring the inflation to a halt. The Federal Reserve has taken strong measures. Consistently applied they will do the job over a number of years. But more is needed. Government spending must be brought under better control. Government policies raising prices must be turned around. Energy must be better conserved and its production encouraged if we are to avoid a constant menace to our price level as well as our national security from the side of OPEC. Expectations of real wage gains must be reduced so that they more nearly approximate average gains in productivity. None of these actions is easy; all will take time to become fully effective.

But if the government cannot immediately eliminate inflation, the principal source of our economic difficulties, the government could very well take action to reduce some of the damage already done by inflation, particularly to savers and investors. It is these groups that are the most exposed. Others, including wage-earners and even social security recipients, are in practice largely indexed. The government could ease the burden of inflation to these most exposed groups, if it chose to do so, in many ways. It could reduce taxation of the income derived from savings. It could reduce taxes on the income itself that is going onto savings. It could gradually phase out interest-rate ceilings, both on depositors and mortgage lenders, consistent with the condition of thrift institutions. Some of this may now be underway as indicated by the movement of the Depository Institutions Deregulation Act in the Congress. The inflation tax levied on business investment and on capital gains could be eased.

The argument against such measures sometimes heard, that it would not be fair to protect some sectors against inflation unless all could be protected, strikes me as totally without merit. In fact, many sectors already are protected. Moreover, if the reasoning were valid, we might as well abolish the police on the grounds that unless everybody could be protected against crime, it would be unfair to protect anybody. Until the battle against inflation has been brought to a successful conclusion, action to blunt its impact is in order.

Savers and Borrowers

The most severe imbalance in our society which directly affects thrift institutions is that between savers and homeowners. Over the last ten years, the median price of existing homes has risen by over 150 percent. That means a rise from about $22,000 to about $57,000 or, on average, $3,500 per year. The homeowner thus has had a second income, equal to about one-fifth to one-third of his median ordinary income, and he has usually been able to defer even the payment of capital gains taxes on it.

Meanwhile, the annual losses to savers from inflation on their household financial assets, including equities, add up to a total of about $1.7 billion in current dollars over the past ten years. This is almost equal to the total financial assets held by households at the end of 1969. In current (depreciating) dollars, to be sure, savers approximately doubled their holdings since 1969. However, in constant dollars, household financial assets were just about the same in 1978 as in 1969. The savings of these ten years have gone down the inflation drain. This has been compensated only in modest degree by a taxable inflation premium in the interest rate.

Homeowners, to be sure, feel aggrieved on their part because their enrichment has been accompanied by higher property taxes and maintenance costs. Nor have most homeowners been able to cash in on their gains, but many have in effect liquidated these gains, free of tax, by borrowing against them. Meanwhile, they have been able to deduct their mortgage interest for tax purposes. This interest, of course, contains an inflation premium, which is the functional equivalent of debt amortization. Thus the tax system subsidizes debt repayment.

Surveying these inequities, I find myself compelled to wonder whether President Carter's pre-election idea of disallowing home mortgage interest for tax purposes would not indeed have been a good one if implemented three years ago. Suppose that it could have been coupled with a device by which the added Treasury revenues were used to overcome the consequences of low interest rates on old mortgages. It might have been done through interest rate insurance, through purchase of old mortgages, or perhaps in some other way. That would have created a mechanism to redress in some measure the unequal balance between homeowners and savers. The thrift institutions would be better able to stand up to periods of financial pressure. Home prices would not have been bid up to such speculative heights. More young people in low tax brackets wanting to buy their first home would have had access to the market. The danger that the housing price bubble might burst would have been better held in check, if such a means of recapturing homeowners' gains had been available.

I doubt that this approach would be viable today, quite aside from the political difficulties of ending the deductibility of mortgage interest although in some countries this deductibility has been eliminated, or else never existed. I raise it as a hypothetical possibility because I believe that, where thrift institutions and particularly mutual savings banks are concerned, this is a time for bold thinking. We need to think not only of the immediate situation, but of the longer run future. The immediate problems will be solved more readily if we know more about our long-term direction. Let me turn, therefore, to that subject.

Longer Run Possibilities

Looking toward the longer run future, I see, as most do, a growing homogeneity of our financial institutions. The market has become very sensitive to small advantages enjoyed by one form of financial intermediary or another, whether it be in the field of interest rates or of financial services. If there is to be greater homogeneity in these regards -- and that applies also to competition with the open market -- there must be greater homogeneity in the kinds of assets that intermediaries can acquire and the operations that they can conduct for their customers. This implies broad consumer lending powers, and, in the longer run, commercial lending powers, as well as variable rate or rollover mortgages, and other asset powers. It implies also a gradual phasing out of Regulation Q, ending of the differential of one-quarter of one percent, and paying interest on transactions balances with reserve requirements on all such balances. It also means that institutions should be treated equally with respect to taxation. I shall return to some of these proposals presently.

Again, looking toward the more distant future, I would hope that it will not involve any diminished role for the mutual form of organization, especially not through conversion into stock institutions. The mutual form, in my opinion, has great merit both economically and politically. Economically, it allows the institution to avoid the payment of dividends which, in a broad sense, means to avoid an element of cost. For institutions that do not aspire to grow with great rapidity, access to the stock market is not needed. Indeed, not many commercial banks in recent years have taken advantage of their ability to have access to the stock market. Had commercial banks possessed the ability to channel all their earnings into surplus, they would be stronger institutions today. Politically, the mutual form moots the social conflict over property rights. The customers are the owners. There are no profits that critics can call obscene. If our capitalist system ever should have to yield to a different form, which I do not now foresee, mutualism could even be the wave of the future.

In looking at both the more distant and the nearer future, we should examine the possibilities of effectuating marriages between mutual savings banks and commercial banks. The authorization of the corresponding powers for mutual savings banks would provide an opportunity. It is uncertain how effectively it could be seized by institutions that lack experience and expertise. Mergers with commercial banks might make this easier. Such mergers might raise difficult legal and institutional issues. If those could be resolved, mergers could still present a threat to the continuation of the mutual character of a merging savings bank. But it does not seem inconceivable that ways could be found that would preserve this character.

The Immediate Future

Allow me now to turn from these more distant vistas to the here and now. In particular I would like to focus on the interaction between mutual savings banks and the Federal Reserve. There are several fields of such interaction. The most immediate one is in the area of controlled interest rates. One problem is how to administer Regulation Q in a way that maintains the viability of the thrift institutions while reducing inequity to the small saver. A twofold threat to savings banks must be borne in mind: If interest rates are unattractive, they may be disintermediated. Truly attractive deposit rates, on the other hand, threaten the institutions' earnings -- given the current restrictions on asset powers. Together with the other regulatory institutions, the Federal Reserve took a very small step to help the small saver by authorizing the four-year CD tied to the Treasury bill rate with a margin of 1.0 percent for thrifts and 1-1/4 percent for commercial banks. The response has been, perhaps understandably, very disappointing. There may be room here for a somewhat more generous approach.

There has been Congressional interest in according the small saver a better deal and the Senate has just enacted language endorsing the concept of reducing the size of the money market certificate from $10,000 to $1,000. The legislation does contain safeguards, recognizing that such a reduction could pose a major threat to the savings bank industry. Industry analysts have projected a rise of interest costs, if such instruments were offered, that would more than erase current profits. But, in the presence of rapidly growing money market mutual funds, you will have to ask yourselves whether the market now is generating an answer for the small saver that you will have to take into account in your own thinking.

The Senate has also voted to phase out Regulation Q ceilings over a period of several years, raising these ceilings with appropriate safeguards by at least one-half percent per year. The Federal Reserve has supported a move of this kind, in the belief that over time adjustments to market realities are inevitable.

As part of this process, of course, the quarter percent differential would disappear -- a development viewed by your industry with concern. The Federal Reserve supports such a development, even though we do not regard it as our function to favor commercial banks in their competition with other institutions. Nevertheless, the growing movement toward greater equality of powers for all financial intermediaries cannot logically be made consistent with differentiation in the amount of interest the two types of institutions can pay.

At the same time, the Federal Reserve welcomes the expansion of NOW accounts or their equivalent throughout the country, which would be helpful to savings banks in some states. However, an important condition for the execution of an effective monetary policy is that reserve requirements be maintained for all transactions balances, including NOW accounts.

The Federal Reserve fully supports efforts to raise usury ceilings to realistic levels or eliminate them altogether. Particularly at a time when the Community Reinvestment Act imposes regulatory sanctions intended to encourage financial institutions to meet more equitably the credit needs of their communities, it is illogical if state laws simultaneously demand that the communities' needs be met at interest rates below the cost of money. National banks can override usury ceilings to the extent of 1.0 percent above the Federal Reserve's discount rate. This has brought some relief to borrowers in states where usury ceilings made loans hard to obtain but does not help MSB's to lock in current high mortgage rates. The Senate has passed a bill suspending state usury ceilings for business and farm loans of over $25,000 and revoking the state usury ceiling on mortgage loans, although states could act to set aside this exemption.

Federal Reserve reserve requirements also are the subject of intense Congressional attention. The House has passed a bill which subjects transactions balances over a rather high exempted amount at all depository institutions, including thrifts, to reserve requirements and provides residual authority for setting reserve requirements on certain categories of time deposits. The Federal Reserve, incidentally, is considering including such transactions balances within a version of the narrowly defined money supply as a means of improving our monetary policy procedures. The Senate is still considering this complicated and controversial area of legislation. As you know, the Federal Reserve recently has moved to rely much more heavily on reserve requirements and reserve management in order to gain a firmer grip on the monetary aggregates. It would be very unfortunate if a significant and growing volume of transactions balances were to escape this grip.

Exemptions from reserve requirements for smaller institutions, up to transaction deposits of $35 million, have been voted in the House version of the bill. The Federal Reserve, moreover, has proposed to allow banks to share in its earnings if it decides to call for supplementary reserves needed for the conduct of monetary policy. This proposal remains under consideration in the Senate Banking Committee. However, it should be noted that the high revenue from required reserves is mostly the result of inflation. Inflation has driven up interest rates and made sterile balances very costly. Revenue from reserve requirements would shrink drastically if interest rates were to return to noninflationary levels. The government in effect is taxing the inflation for which it bears much of the responsibility. The merit of that procedure is hard to discern. In any event, reserve requirements on transactions balances would be a modest burden for thrift institutions if personal time and savings deposits were nonreservable, as seems to be the intent of all pending legislation. I could fully understand if your reaction to these ideas were to depend on whether money market mutual funds are subjected to reserve requirements or not. Personally, I would favor such action.

Finally, let me turn to the matter of Federal Reserve assistance and, possibly, Federal Reserve membership for mutual savings banks. You should not be disturbed by press stories of contingency plans being readied to deal with problem situations among mutual savings banks. It is any central bank's job to have such plans. We have had them since time immemorial. We have also always had plans in bureau drawers for dealing with problem situations among commercial banks. That does not mean that we expect problems to occur. Like other regulatory agencies, we are simply trying to do our job.

We would, of course, feel more comfortable if mutual savings banks were members of the Federal Reserve System. Discussions on that subject have been going on over the years and have been left in an inconclusive condition. The main obstacles have to do with reserve requirements on one side and the nature and duration of the discount window facilities that the Federal Reserve could offer on the other. As the matter now stands, the Federal Reserve can lend to mutual savings banks but would have to do so under specified emergency procedures. Even if mutual savings banks were to become members, present discounting practices would have to be changed to make credit available for the prolonged periods for which mutual savings banks may need such credit.

The legislation now in the Congress may resolve this impasse. If a mandatory reserve system is enacted, the intention of the Congress seems to be to make the discount window available to all depository institutions that offer transactions-type accounts to the public. This would still leave open the question of the duration of such assistance, which for commercial banks is presently quite limited. The House has passed legislation that looks towards a more flexible administration of the window.

In conclusion, let me stress again my opening theme. The mutual savings bank industry today is suffering from a condition which constitutes a grave problem for the entire economy. Even though the impact is particularly severe on your industry, you know that you are not alone. Whatever is done to bring inflation under control will in the longer run also help the mutual savings bank industry. That is the course on which we must persevere.