Remarks of

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THE OUTLOOK FOR SAVINGS - PROFITABILITY VERSUS INTEREST RATE SQUEEZE

It is a pleasure to be with you today as you share experiences and attempt to plot a course for effective operations in a period of dynamic banking. Judging by your program, you will have ample and informed discussion of how to secure appropriate shares of savings and how to employ them in the market place.

Having so recently been on the firing line of responsibility for an individual bank, and now being more closely involved in public policy, I believe that I can best serve you by

(1) Briefly reviewing the factors responsible for the abrupt turnaround in the savings market and the more restrictive monetary policy which has gradually emerged this year.

(2) Examining the risks and rewards awaiting the commercial banker who aggressively expands his role as a savings market intermediary.

In a sense, the latter is simply a review of the recurring problem of meshing of public policy objectives with the goals of the individual banker.

A number of bankers here today must be confused, if not downright irked, at the seemingly abrupt change during 1966 in the attitudes of the monetary authorities with respect to savings and time deposits. Contrasting the previous five-year period of monetary expansion with events of this year, some of you might be reminded of the old story about the Texas cowboy who kept avoiding a particular Mexican lass in town. One morning as he tied his horse at the general store, she caught up with him and put this question: "Down by the reever in the moonlight you always call me honee--in town you call me Chollo. Why ees thees?"

During most of the current expansion monetary policy has been more effective because commercial bankers have expanded their role as savings intermediaries.

Available unemployed resources--human and other--made expansion of credit possible without putting upward pressure on price levels. Large flows of savings, being generated as disposable incomes grew, had to be put back into the economic stream as investment. Institutional factors, accumulated over many years of trial and error, limited the ability of some savings institutions to diversify the employment of these growing streams of savings.

Several other factors made it appropriate for the monetary authorities to welcome a more aggressive approach by bankers in broadening their participation as savings middlemen. Up to the end of 1964, new investment by corporate business had responded to stimulative fiscal measures but most of its net financing still came from internal sources. On balance, however, the private savings were still being augmented by creation of additional bank credit, made necessary because some savings were impounded in specialized channels. Just a year or so ago, "spill-over of savings into foreign uses" and "deterioration in the quality of credit" were the main topics of the day. And of course, the Federal Reserve System was criticized for continuing an expansive monetary policy during a period when institutional changes were not being made rapidly enough to efficiently utilize financial savings.

To put it another way: When the current recovery began, the real savings gap, in the form of under-utilized resources, was large. The flow of financial savings was handled inefficiently relative to putting these resources to work. In spite of initiative from several sources, revamping of institutional channels for allocating financial savings was not strong enough or fast enough to keep up with the needs of the economy. Thus, further encouragement of aggressive innovation by commercial bankers in the savings field, together with expansive monetary policy, was entirely appropriate.

Lacking in this picture, of course, was the ability to see the future in full, no less by the central bankers than by the individual commercial banker. Neither could see every detail or every difficulty to come out of an extended period of expansion that was to completely diminish the margin of unused resources. Could we have foreseen this, we could have given you a more definitive blueprint of official attitudes toward expansion of commercial banks as capital market intermediaries.

True, we all had a great deal to go on as we guided our respective actions from day to day. We had the benefit of our knowledge of human nature and of previous recent swings from underemployment of resources toward full employment. Most of all, we had the long record of the history of banking in this country. Reference to these sources told us then, as they tell us now, that both risks and rewards are involved in the business of gathering savings and putting them to work to earn a profit.

Here, let me digress for a moment to a few remarks on the "new banking philosophy," of which the broadened role of bankers as savings middlemen is a part. Some aspects of this current philosophy may be new in their present form: The view, for example, that liquidity can always be bought in the market place instead of provided by the individual bank. That commercial bankers now play a greater role in the administration of savings flows is not new.

In fact, commercial bankers have always been useful as savings middlemen. In the country's early days they very effectively channeled savings to the formation and preservation of a national government. In the 1830-50 period they were foremost in bringing "old-world" savings to our capital-deficit economy in the form of merchant credit. And they were foremost in distributing the savings of commerce, manufacturing, and shipping from eastern centers to the hinterland.

In the latter half of the 19th century they were the prime movers, along with the infant investment bankers, in bringing huge amounts of European savings to be invested in our industries and railroads. As domestic savings grew more significant in the present century, commercial banks were substantial middlemen in their mobilization and use, particularly up to the early 1930's.

So the role of the commercial banker in savings expanded and contracted as waves of prosperity and depression succeeded each other. With each major wave, the primary source of financial savings changed. Very early in our country, ocean traders and international merchants generated the bulk of savings. Gradually domestic merchants, tradesmen, and other small businessmen and professional people came to be predominant generators of domestic financial savings. And by the 1920's, the ever-larger corporate business assumed greater importance, as did the ordinary working man. And since World War II, of course, the consumer sector has emerged as the chief supplier of financial savings in our economy.

As these selected examples underscore, bankers have had to face substantial changes in the environment in which they sought to expand their financial services. Time after time during periods of underemployment of resources, their enlarged role was encouraged by economic events and by public policy. In such periods banking had the opportunity to become dynamic, aggressive, and innovative. However, almost every such period produced an erroneous assessment of its permanence, with some elements in banking concentrated too much on rewards and too little on risks.

I have been too recently in your boots not to understand your resentment when the transgressions of the few are over-emphasized and the achievements of the many are played down. All of you know of isolated cases of poor judgment and of the well-publicized cases of misuse and abuse of some of the newer techniques utilized by banking in the past few years. But in the current period of expansion--which we hope can be moderated to a pace so that it can be further extended--our banking system has successfully avoided many of the abuses of earlier periods of great change. Perhaps it would be useful, however, to consider some classes of risks and rewards which good judgment and good banking practices can balance.

You know, better than anyone else, what your objectives and hopes of reward encompass-whether they be greater growth, better community service, higher profit rates, or other specific goals. You also know that greater efficiency in gathering savings and improved judgment in the allocation of their uses are essential in achieving those goals through expanded service in savings administration. I suggest, however, that these attributes, today more than ever, are not <u>sufficient</u> to avoid having external risks check many of your apparent achievements.

Think with me for a moment about one class of risks--those generated by the market itself. During the last four or five years, a number of bankers may have subscribed more than prudently to some facet of "the new philosophy" of banking: Perhaps to the idea that liquidity can be bought in the market place. I further suspect that some bankers who went along with the view that loan-to-deposit ratios can be safely increased to 70 or 80 percent may now be having second thoughts, if not real problems. Even some who did not "buy" all of the new philosophy, but who bid aggressively for savings and time deposits and "went long" for yield in their investments, are now locked into a lengthy workout period. One of the more poignant ironies of these examples is that in many cases the earlier that banks became aggressive--and successful--in building up their savings and time deposits, the greater their book losses have mounted.

In the longer run, of course, it goes without saying that the more the commercial banker succeeds in competing for savings, the more he becomes like his specialized competitor. In short, by lengthening his assets he becomes more and more subject to the risks of the market. Reinforcing this difficulty is the obvious one involving major swings in interest costs on savings as competing interest rates rise or fall.

Fortunately the periods of extreme pressures on resources and hence on interest rates do not last forever, and the pressures are not always from the same direction. When the turn comes, the bank that has served its community well by expanding its role as savings middleman may count the cost of a temporary interruption in growth as a small price to have paid. Having been operated prudently, it will have weathered the storm and will have a more solid base of experience and expertise in making the most of a time when lenders will again be courting borrowers.

The direct impact of market risks upon the individual banker reflects not only changing balance in resource utilization in the domestic economy in the short run, but also political developments. Many of the latter are international and lie beyond our control.

For example, domestically we are just beginning to see some results from the increased application of fiscal measures. Whether these were delayed because of lack of experience with the proper mix of fiscal and monetary policy in an extended period of near-full employment or because of presumed political unpopularity is irrelevant. The result is the same: Monetary policy has had to carry more of the load in dampening excess demand, with effects on interest rates and credit flows too well known to require elaboration here.

Throughout the history of our evolutionary financial system, there has been an undercurrent of fear of too-powerful banks. A continuing risk of promoting individual goals is that abuses, mistakes in judgment, and even success itself in developing new techniques seem to rejuvenate this fear and widen the audience for its spokesmen.

Your competitors in administering savings have developed strong positions and the machinery to protect them in the legislative halls and in the forum of public opinion. Their task is made easier if you get carried away in a particular direction. How much different might the situation have been recently had those banks which were most successful in increasing their time and savings deposits been in a position to expand their mortgage lending during the past six months rather than cut it back?

It hardly needs reiterating that international risks have increased greatly over the years and show no signs of early abatement. Even if the extent of further diversion of resources to cope with Southeast Asia could be nailed down for an extended period, we would still have the problem of managing our major role in the free world's reserve currency system. These and other international problems will continue to limit your freedom and ours in appraising risks and acting upon such appraisals.

Change in our whole system of translating financial flows into real resource utilization has accelerated in recent years. Further change appears certain, not only in the variety of services provided by particular types of institutions but also in the range and quality of supervision demanded in a dynamic economy. In my view a tremendous opportunity exists for that banker who can successfully apply the most modern techniques in broadening his service role. He must do so, however, with increased awareness that a balanced approach to risks and rewards is one of his most critical problems.

Monetary policy will continue to seek, as it has sought, to promote the best combination of economic growth, full employment of resources, and price stability. Undoubtedly, at times more rapid expansion of banks' role as savings intermediaries will promote that objective. At other times the opposite may be true.