

Mid-Year Meeting of the
National Association of Mutual Savings Banks
New York, December 8, 1959

Frederick L. Deming, President
Federal Reserve Bank
of Minneapolis

"MONETARY POLICY AND ITS RELATIONSHIP TO SAVINGS BANKING"

It is a double pleasure for me to address the mid-year meeting of the National Association of Mutual Savings Banks. I would be honored at the invitation at any time, but it is especially pleasant to be asked during John de Laittre's administration. We in the Twin Cities quite naturally are proud of your president; we know he is giving you strong and intelligent leadership.

In Minneapolis, the Federal Reserve Bank is quite close to savings banking. In fact, we could not be much closer in physical terms. The Farmers and Mechanics Savings Bank and the Federal Reserve Bank stand back to back. Your president has been known to state that his institution is backed by all the physical assets of the Federal Reserve Bank of Minneapolis.

The topic assigned to me is "Monetary Policy and its Relationship to Savings Banking". The linkage runs through money supply, liquidity, savings and investment, and interest rates. I intend to try to trace those relationships rather technically throughout much of this talk. But before doing this I want to underline some general but highly important points.

An old adage says that money makes the world go around. I think it might be said more accurately that saving makes the world go around. Saving is what finances investment, investment creates capital and capital produces economic growth and well-being. We have been fortunate in this country to have attracted saving, first from abroad and then from our own resources, in sufficient amount to finance the world's greatest aggregation of capital in one nation. As a result we have experienced great economic growth and have a major share of the world's production. The great debate now going on

in this country with respect to economic policy centers on two questions: how can we best maintain or better our past growth records and how can we distribute the fruits of growth so as to make for a better, stronger United States and contribute to a better, more peaceful and more democratic world.

In a speech made in Minneapolis the other day, John Cowles of the Minneapolis Star and Tribune raised the question: Will America Survive in Freedom in the Coming New World Order? In most graphic illustration he called attention to the importance of saving and capital investment. Let me quote him briefly:

"The per-capita income of....Asians, Africans and Latin Americans is only slightly more than \$100 a year, or less than one-twentieth of the per-capita income of Americans.

"The United States alone has 47 per cent, or almost half, of the total.....world income above \$100 per person.

"If one adds together.....the amount above \$100 per inhabitant of Canada, Great Britain, Japan, Australia and the European countries including Russia, that total is only slightly greater than that of the United States alone.

"These countries that I have mentioned, including the United States, therefore have between them more than 95 per cent of the whole world's total income above \$100 per person.

"In other words, the rest of the world - Asia, Africa, Central America and South America combined - has less than 5 per cent of the world's total income above \$100 per person."

The point is obvious; there has to be income to generate saving and there has to be saving to generate development. Insofar as underdeveloped countries are concerned, some means must be found to channel more capital to them so that they can break out of the confines of their low income - low saving - low investment prison. And, if we are to play any part in

this we must continue to produce a high rate of saving here, for our own sake and for the sake of the free world.

We want to continue to grow, however, in freedom which means that we have to obtain our savings voluntarily. Savings can be forced out of even very low income by a ruthless dictatorship. This is exactly what is done in Iron and Bamboo Curtain countries. Forced saving also can result from the maldistribution of income resulting from inflation, although after a time, in a free nation, people wake up to the fact that this is happening and then the whole saving process stops. What we have to do under our system of freedom is to provide a climate favorable for saving and for investment which means that saving must receive some reward and that savers must receive some assurance that the value of money will be reasonably stable.

Now let me turn to tracing the linkage between monetary policy and savings banking in a more technical manner. Savings Banks are part of a group of institutions for which someone has coined the impressive term "financial intermediaries". These institutions perform a primary economic or monetary function by transferring funds from savers to spenders. Along with savings banks, the term "financial intermediaries" includes such institutions as savings and loan associations, insurance companies, credit unions and the like. While these institutions differ in organization and in the forms in which funds are obtained and invested, they all transfer funds from savers to spenders.

These financial intermediaries differ from commercial banks in many aspects, but from a broad economic point of view the major difference lies in the fact that the commercial banking system can and does create money as it lends and invests, while the financial intermediaries do not. The funds that savers place in financial intermediaries are money. In exchange, the savers receive promises to pay or shares in profits or both.

The forms of obligations they receive are very liquid financial assets. They

are what may be called "near money" and ordinarily can be exchanged for money with ease. But these obligations in themselves are not means of payment. They have to be exchanged for money to become means of payment. Incidentally, time and savings deposits in commercial banks fall in this same "near money" category. But demand deposits at commercial banks are a means of payment and thus are money, as is, of course, actual currency and coin.

What savings banks and the other financial intermediaries can and do do in their operations is to affect the liquidity of the economy. Money itself, of course, is the most liquid asset and is the ultimate source of liquidity. Thus the real liquidity of the obligations of financial intermediaries must rest upon the availability of money itself. But these institutions, acting as risk buffers standing between savers and borrowers, can increase the amount of liquidity around by pooling money savings and channelling them into investments, both new and existing.

In performing this function, the financial intermediaries make possible a more efficient use of the money supply. To say this in another way, a given supply of money can support a larger volume of spending if people are willing to keep a smaller part of their liquidity needs in real money form and a larger part in financial savings form. Or to say it in still another way, the presence of financial intermediaries makes it possible for money to work harder, to have a higher velocity or turnover.

This very fact, coupled with the fact that financial intermediaries have grown tremendously in recent years, has caused some observers to contend that monetary policy action can be thwarted by the actions of financial intermediaries. I do not intend to explore this point very deeply nor to offer any firm conclusions concerning it this morning. I think it might be useful, however, to outline some of the points involved.

Traditionally central bankers have thought mainly in terms of the quantity or the supply of money and their operations have been designed to affect the quantity or the supply. They have known, of course, that total spending is affected by the rate of use as well as by the quantity of money, or to say it in another way, by the presence of "near money" and the liquidity of the economy. The assumption has been that operations to affect the money supply can accomplish objectives successfully by being made sufficient to offset changes in velocity or to take account of the liquidity of the economy. Thus such factors do not necessarily prove to be real or practical barriers to effective monetary policy.

Incidentally, this is one big reason why central banking has been characterized as an art rather than a science and why operating central bankers are not very much impressed by proposals that the money supply be changed by constant or specific amounts or percentages from period to period.

The point raised by some modern observers, however, is that the great growth of the financial intermediaries has resulted in a relative decline in importance of the money supply factor and a very substantial rise in importance of the velocity or liquidity factor. Therefore, it is said that operations on the money supply factor have to be much more forceful today than was true in the past, and, in the extreme view, as a practical matter they can not be made sufficiently effective. So far most monetary theorists and most central bankers have not accepted the views of these observers.

Now let me turn to the roles of savings and interest rates in our economic system. There seems to be a fairly wide consensus that our economic system should perform in such a way that (1) goods and services wanted most by people as individuals and as a whole are produced, (2) purchasing power of money is kept reasonably stable, (3) unemployment is held to a minimum, and (4) a satisfactory rate of economic growth is achieved. The relationship

between savings, interest rates and these objectives is a question of considerable importance.

There is no great amount of controversy about the economic function of saving. Some people abstain from current consumption and the funds withheld are available to people who want to spend more than their current incomes. Ordinarily when people borrow they obtain funds that other people have saved. The other source of borrowed funds is created money, a factor I want to bring in later.

Some saving flows to consumer-spenders who want more goods and services today than they can command with their current incomes. Most saving flows to producer-spenders who want to invest in additional productive capacity. The funds withheld from current consumption by savers thus focus in part on the stream of consumer goods as consumer borrowers take them over, and in larger part on the stream of producer goods as producer-spenders take them over. Shifts in the amounts and proportions of these funds thus stimulate or retard consumption or investment and thus affect the level and make-up of the national production.

There is considerable controversy over the determinants of demand and supply of savings. Most economists agree that the level of income has a great influence on the level of savings, at least on voluntary savings. If income is below or just equal to subsistence needs, voluntary saving hardly will take place. This is, of course, the major problem of the underdeveloped countries.

The influence of rate of return on the total amount of saving has generated considerable argument. Some people contend that rate of return is of no consequence, that people would save approximately the same amount under different rates of interest or profits. Some even argue that the rate effect may be perverse; low rates may stimulate saving because savers need a given

amount of money income from their savings and thus low rates require more savings to produce the income. I must say that I find a kind of Alice in Wonderland quality about these lines of reasoning - both in their logic and in the light of what actually happens.

Perhaps the most striking recent example of savers' responsiveness to rate of return was the tremendous success of the "Magic 5's". This example, of course, reflects the response of individual savers rather than the response of total saving. It seems illogical, however, to admit that a given saver is sensitive to rates and then to argue that savers in the aggregate are not. So while I agree that there has to be income to have saving, I must also conclude that rate has some influence. Certainly it has great influence in channelling saving to various segments of the economy.

It also is argued by some that demand for savings is not influenced by rate. I find it equally difficult in logic and in experience to accept this thesis. Of course it is true that interest costs are merely part of total costs, sometimes of greater importance, sometimes of lesser importance. Thus a high rate does not discourage all borrowing or a low rate encourage it in every case. Nevertheless, if price has any meaning at all in our economic system, the price of money must have some influence on the demand for money; and surely the other side of the picture has validity in real world experience; borrowers do bid for funds in financial markets and I am told that borrowers have been known to complain when rates advance.

I might point out in passing and almost without discussion that changing interest rates also have an effect on the availability of funds through the changes which result in the values of existing financial assets. To many economists this effect is a far more powerful influence than the effect on demand for funds. If prospective lenders cannot shift from existing financial assets readily or without appreciable loss, the availability of

funds is lessened. Conversely, when prices of existing financial assets rise and there is a ready market for them, availability of funds increases.

Well where do these points take us? To the position that the interest rate, the price of money, equates the demand for and the supply of savings. Borrowers and lenders must agree to the terms that transfer purchasing power from one to the other and among these terms is the interest rate. If, at a given rate, people are willing to lend more than others are willing to borrow, the rate is forced down by competition. On the other hand, if demand for funds exceeds supply at a given rate level, the rate is pushed up.

Now let me note three other factors which affect demand-supply relationships and hence interest rates so as to make this a realistic picture. First, expectations have a considerable influence; not only "what is" but "what may be" affects savings and rates. Second, taxes have a bearing on costs, including interest costs, and hence rates are influenced by this factor. Third, legislative actions may either shelter certain credit markets or influence the flow of savings to certain users or both. But while these all have bearing on demand for and supply of funds and on interest rates, they do not, as I see it, sufficiently change the basic situations in which borrowers and lenders must agree on terms of transferring purchasing power, to seriously impair the demand-supply analysis given above.

At this point, however, I must introduce another, far more important factor than those noted above - the factor of created money. I referred earlier to the fact that the commercial banking system can create money by lending or investing. This created money constitutes a large part of the money supply and it is this factor with which central banking deals directly. Additions to the money supply affect the liquidity of the economy, can change the demand-supply relationships in the savings-borrowing situation, and thus can affect the level of interest rates.

The point most often at issue, and certainly the one at issue today, is: why not create enough new money to satisfy demand at a low level of interest rates? Let me try to answer that clearly.

Over the long pull the demand for real investment must be matched by the supply of real savings. That is, these must match if we have high employment and a growing economy operating at or about at its current capacity. This is true because economic resources are scarce and in a capacity operation resources going for investment purposes have to be taken from consumption purposes and saving represents the withholding of spending from consumption.

Created money then can be no more than a relatively short-run substitute for savings in financing investment. It can bridge temporarily gaps between the flow of current savings and needed investment when real resources are available because the economy is operating below capacity. It can and does, of course, serve a number of other purposes and it is important that the money supply be allowed to grow as the total economy grows so that financing stringencies do not impede growth. But this is a far different approach than one which would merely add to the money supply because borrowers wanted funds at low interest rates.

If created money tries to do this, its actions become self-defeating in two senses. If the money supply is increased unduly it leads to undue upward pressure on prices and the familiar cost-price spiral. I do not propose here to describe the evils of this inflationary process. They are well-known and seem to be less and less acceptable to most people. Here, I merely want to note their effect on saving and I can do no better than to quote a recent statement of the Managing Director of the International Monetary Fund, Per Jacobsson, who says, "...once people wake up to the hurt inflicted upon them by the inflation....they will....hasten to buy whatever they can

to avoid loss of real earnings. When that happens, the normal flow of voluntary savings will be diminished, and be increasingly diverted to speculation...Then the game is up, for without a ready flow of savings no economic progress can be sustained."

Second, it is not possible, except under special circumstances or over short periods, for undue amounts of created money to keep interest rates lower than normal demand-supply relationships will keep them. The undue money supply increases lead to price increases and to the process described in the Jacobsson quotation. Then the demand for funds grows as prices rise and as savings are diverted. Then interest rates rise and the whole situation is about the same as before except that prices are higher.

It is now time to pull the threads of this discussion together in summary form. Saving serves the economic purpose of financing investment which adds to productive capacity which promotes economic growth. A high level of saving depends on a high level of income but is influenced by the rate of return. The rate of return also is a factor in the demand for saving and thus the interest rate serves to equate demand for and supply of savings. The rate of interest also serves to channel savings into more investment or more consumption, or into types of investment. Additions to the money supply can reconcile temporary imbalances between demand for and supply of investment funds but should not over the long pull impede the balancing of saving and investment at a normal demand-supply equated interest rate. To attempt to do more is likely to inhibit the flow of saving rather than lead to lower interest rates.

There has been a lot of comment in recent years to the effect that low interest rates are good and high interest rates are bad. I find it difficult to judge interest rates in this fashion. What we want, in fact what we have to achieve, is an interest rate structure low enough to stimulate

investment, high enough to stimulate savings, and flexible enough to serve the economic purpose of allocating funds, under varying economic conditions, to uses which will best promote the welfare and strength of the nation. Thus there is no given level of rates that is either good or bad in all instances; at times high rates are proper, at times low rates are proper.

I might comment in passing on the relevance of the above analysis to rates paid on Federal Government borrowing. In an economy where savings are voluntary, and where they have to balance investment over the long pull, the Government has no choice but to pay what is required for savings when it borrows. Normally rates on Government borrowing will be lower than rates paid by competing borrowers because the Government is a preferred borrower. But the Government cannot dictate the rates it will pay in a free economy, except in the short-run, and even then it may incur the costs of money supply inflation with nothing but transitory relief. It can, by intelligent debt management, lessen the day to day impact of its borrowing and hence, perhaps, in the long run lessen its borrowing costs. This is a primary reason why statutory ceilings on interest rates on Government securities are unwise; they force debt management into unnecessarily confining programs.

In concluding this talk I want to come back specifically to my assigned title - the relationship between monetary policy and savings banking. As I see it, there are two kinds of relationship: one a more or less direct link between monetary policy and savings banks, the other a common interest in promoting saving.

Monetary policy has a direct influence on the money supply, the source of liquidity, and thus on the liquidity of the economy. Consequently, it has an effect on the willingness of savers to hold balances in various forms and on the terms under which they hold them or part with them. This links monetary policy fairly directly to savings banking both in respect to

the balances held by savings banks and the terms under which they are attracted and transferred.

Savings bankers and central bankers also share, however, a common interest in saving. In a very real sense, every American shares this common interest because saving makes economic growth possible. But the common interest between savings bankers and central bankers is closer. Both recognize that saving is vital to growth, but they realize also that voluntary saving in an atmosphere of freedom is the key to growth in this country, that one great requirement for this is stability in the value of the dollar, and that another great requirement is the proper allocation of funds for investment.

Savings banks are instruments of free choice which attract savings and transfer them to consumer- or producer-spenders. They serve an economic purpose by using their skills to evaluate, in their own areas, projects seeking funds and to channel such funds to the most worthy projects. Thus they play a vital role in promoting an efficient allocation of funds.

Thus if monetary policy plays its proper part by keeping the money supply in balance with the needs of a growing economy at a high level of employment, it produces a climate in which savings institutions can perform their traditional function efficiently and well in the interests of the nation and its welfare.