INFLATION, THE THRIFT INDUSTRY, AND THE FED

Remarks of

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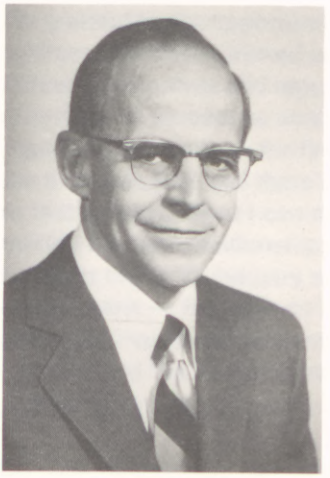
Fifth Annual Interest Rate
Forecasting Seminar
Federal Home Loan Bank of Seattle

Seattle, Washington
February 27, 1981



The thrift industry faces a difficult earnings situation, with its high-cost liability structure and its overhang of low-yielding mortgage portfolios. Over the long-run, says Mr. Balles, deregulation of the industry will help cure that situation — providing the industry with an opportunity to reduce its reliance on the volatile housing industry, as well as an opportunity to compete more effectively for funds in the open market. But the industry's basic problems can never be overcome without an attack on high inflation and high interest rates. The Federal Reserve can do very little to reduce the cost of thrift-industry funds without first reducing the growth of the money supply, as a necessary step in reducing the rate of inflation and hence the levels of interest rates. But any Fed attempt to reduce money growth without parallel reductions in Treasury financing demands could lead to severe pressures in financial markets.

I'm grateful for the opportunity to visit Seattle and address this distinguished audience of thrift industry executives and regulators. You've heard a number of perceptive analyses this morning regarding the outlook for financial markets and the thrift industry, and there's little that I can add in that respect. What I can do, however, is to outline the new relationships developing between the thrift industry and the nation's central bank — the Federal Reserve System — and to emphasize our joint interest in confronting inflation and the nation's other economic problems.

Our new relationship can be traced, of course, to the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980 — by far the most important piece of financial legislation of the past generation. The new law means many things to many people; I'm intrigued by the fact, for example, that many thrift industry regulators refer to it as the Deregulation Act, whereas we in the Fed generally refer to it as the Monetary Control Act. But whatever it's called, to my mind it was a badly needed piece of legislation. Over the past generation, the nation's financial structure had become distorted by many pressures — such as widespread financial innovations, shifting competitive patterns, severe inflationary pressures, and inflation-caused increases in interest rates. The MCA — or the Deregulation Act, if you will — was Congress' answer to those problems.

Through the MCA, Congress tried to promote greater competition in financial markets, by providing for the phase-out of deposit interest-rate ceilings and for broader asset and payment powers of banks and thrift institutions. Congress meanwhile tried to promote greater equity and improved monetary control by extending reserve requirements to all depository

institutions with transaction (check-type) accounts and non-personal time deposits. This step also helped solve the problem of a deterioration in the Fed's ability to control the money supply, as caused by declining Federal Reserve membership. This was done by reducing the cost of reserve requirements for member banks and by imposing similar requirements on all insured depository institutions. Moreover, Congress tried to promote greater efficiency in financial markets, by providing access to Federal Reserve services, at explicit prices, for all depository institutions subject to reserve requirements.

New Relationships

With the enactment of this new legislation, the Federal Reserve has established direct business relationships with thrift institutions, and has also begun to make fundamental changes in the way it does business with commercial banks. Altogether, the Fed's financial constituency has expanded about seven-fold, and in our large district, the new constituency (in relative terms) has grown even faster. Let me cite just one example of the importance of this relationship — the need for prompt and accurate reporting of reserves and deposit data. The Federal Reserve requires correct deposit data, to implement a monetary policy geared to the achievement of non-inflationary growth for the national economy — and the new reporting institutions play an important role in supporting that goal.

The Federal Reserve Board of Governors and the twelve Reserve Bank Presidents decided in December to establish liaison arrangements with nonmember institutions as soon as possible, as a means of dealing with the problems associated with implementation of the new legislation. In our own district, we established a 12-member panel, the MCA Advisory Group, which includes

representatives of member banks, nonmember banks, savings-and-loans and mutual savings banks, and credit unions. One of the members is Mr. Robert Weber, president and chief executive officer of Puget Sound Mutual Savings Bank, and two S&L executives are also included — Mr. Joseph Forgatch, executive vice-president of California Federal Savings and Loan, and Mr. George Leonard, chairman and chief executive officer of First Federal Savings and Loan of Phoenix.

In its initial meeting last month, the advisory group considered several major issues dealing with MCA implementation. These included reporting and reserve accounting, charges for Fed services, and access to Fed borrowing privileges. The group's bimonthly meetings should provide a useful forum for obtaining the views of thrift institutions regarding the Fed's service and pricing, including its success in providing services effectively.

Discount Window Policy

Probably the greatest potential area of misunderstanding in this new arrangement concerns the use of Federal Reserve credit facilities. As you know, the MCA provides for access to Federal Reserve facilities — including borrowing facilities — for all depository institutions subject to reserve requirements. This particular issue has generated a great deal of controversy in Congress and in the financial community, especially when many thrift institutions have experienced severe earnings problems — and when the Fed's 13-percent discount rate remains far below other rates at which institutions can borrow funds.

Let me summarize the Fed's basic policy on this issue. (Incidentally, if you don't have a copy of the publication, *The Federal Reserve Discount*

Window, our Seattle office will be happy to provide you with one.) For good reason, the Fed must be a "reluctant" lender of last resort. We create "high powered" money — i.e., banking reserves — when lending through the discount window. In a fractional-reserve banking system, any new reserves can support a multiple volume of new loans and investments through newly created demand deposits — the bulk of the money supply. Thus, substantial and volatile changes in reserves caused by increased discount-window usage could lead to destabilizing changes in money growth, making the Fed's anti-inflation task even more difficult than it already is.

We in the Fed expect that member banks, as well as the additional depository institutions now eligible to use our services, will utilize other reasonably available sources of funds (including their special industry lenders) before turning to the discount window for adjustment credit. The Fed is prepared to advance funds in instances where such institutions require funds on short notice to cover immediate cash or reserve needs, but are unable to gain timely access to their special industry lenders. On these occasions, the Fed will consult and coordinate with the special industry lender as soon as possible. Any such advances should be repaid when access to the usual source of funds is obtained, usually on the next business day. In addition, the Fed is prepared to lend under "emergency" conditions over extended periods of time, but at one percentage-point above the basic rate, to institutions having serious liquidity problems, especially heavy deposit losses. Any such institution of course must provide a remedial plan when applying for credit.

A crucial point to remember is that the discount window is designed to help institutions deal with

liquidity problems but not with earnings problems. The Fed's discount window is available to help meet the needs of any eligible depository institution faced with temporary liquidity strains, so long as the institution remains in a solvent operating position. However, the primary problem facing thrift institutions today is a deficiency of earnings. The interest costs of maintaining funds flows have escalated rapidly, reflecting the roll-over (at steeply rising interest rates) of short-term thrift liabilities. But at the same time, thrift assets have continued to include a sizable proportion of longer-term mortgages that carry returns well below present deposit costs. Thus far, many thrifts have used a large share of the deposit inflows from high-cost certificates to acquire high-yielding short-term assets, and in this way have maintained a cushion of liquidity. While their earnings problems still persist, they have not developed the type of liquidity problem for which the Fed's credit facilities are intended.

All of this may sound like cold comfort to a $750-billion industry which has just survived one of the worst years in its existence. Deposit inflows and mortgage lending at the nation's savings-and-loan associations each fell about 30 percent below the 1979 level last year — and indeed, almost one-fourth of all S&L's showed losses for the year as a whole. Moreover, in today's high interest-rate environment, most are pessimistic about prospects for this year, given the mismatch between their sluggish asset yields and their market-responsive and deregulated liability structures. But can the Federal Reserve help at all in this situation? To many thrift-institution executives, the Fed is part of the problem rather than part of the solution. I would submit, however, that the thrift industry and the Fed have a common interest in overcoming the industry's ills, primarily by working together to

overcome the inflation that has undermined the housing market and thrift institutions generally.

Housing Problems

Before examining this problem of inflation, let's consider the general state of the housing market — the dominant arena for the thrift industry. There's no doubt that the industry has performed very well in housing the nation's citizens over the past decade. The nation produced 17.8 million housing units during the 1970's, a substantial 24-percent increase over the previous decade's production. The maturing of the baby-boom generation meanwhile caused the number of individuals of home-buying age to grow rapidly during this period — yet by the end of the decade, the number of occupied housing units per capita reached an all-time high. The quality of the housing stock also improved, as measured by increases in floor area and by improvements in amenities such as garage space and central air conditioning.

Still, many people are more apt to remember the volatility of the housing industry than its substantial growth, since many fortunes have been lost because of the increasingly wide fluctuations affecting the industry. In the 1973-75 slump, and again in the 1978-80 downturn, housing starts declined by half or more. In addition, first-time home buyers generally found great difficulty putting together the financing for home purchases, despite all the "creative financing" devices now available. And as I've indicated, the thrift industry and other mortgage lenders have made few if any profits the last few years in fulfilling their major role — providing financing to the nation's people for housing.

As you well know, the MCA has provided the thrift industry with one line of escape, by making it possible for them to become "family financial

centers," in the words of former Bank Board Chairman Jay Janis. But while waiting for the dawn of that more profitable world, we must deal with the industry's severe earnings problems, attributable to the high cost of funds and the overhang of low-yielding mortgages. In the last analysis, the problem can be overcome only by defeating the inflation that has created the present destructive level of interest rates. The problem cannot be overcome by any short-term measures to drive down interest rates, because such an approach would only create more inflationary tinder and worsen the industry's long-run situation.

Inflation and Interest Rates

What, after all, is the Fed's role in determining interest rates? Certainly it has some influence over rates in the short run, by helping to push rates up through tighter policy or helping push them down through easier money conditions. But business-cycle conditions also influence rates, as credit demands rise and fall with the cycle. And above all, price expectations heavily influence rates, frequently offsetting other market influences. Today, for example, when people expect prices to rise by (say) 10 percent a year, lenders will demand the "real" underlying rate of interest plus 10 percent, so that they'll be protected against an expected loss in the purchasing power of their money. This suggests, then, that curbing inflation is the only long-run solution to high interest rates.

Curbing inflation requires policies to improve demand and supply conditions in our food and energy markets, which account for about one-fourth of our household budgets. But we must adopt more thoroughgoing measures to reduce our "core" or underlying inflation, which represents the rise in the general price level apart from the "shocks" we've experienced in the food

and energy markets. We must follow proper fiscal and monetary policies if we want to reduce this underlying inflation, which has approached or exceeded nine percent in each of the last several years.

The recent worsening of inflation has gone hand in hand with an upsurge in unit labor costs, because of sharp gains in labor compensation and actual declines in the productivity of the nation's workforce. The cure for that part of the problem is productivity-enhancing tax stimuli, such as those the President proposed last week. But the worsening of inflation has also gone hand in hand with the excessive money growth of past years, when monetary policy was pushed off course by the excessive credit demands generated primarily by Federal deficit financing. And the cure for that part of the problem is to curb rapid money creation, since history shows that changes in money-supply growth affect the inflation rate with roughly a two-year lag. The Federal Reserve thus has embarked on a multi-year strategy involving a gradual slowdown in monetary growth, as a means of curbing inflation without creating a severe recession.

Problem of the Deficit

In an attempt to improve its control over money growth, the Federal Reserve changed its operating techniques in October 1979 — in effect, by placing more emphasis on controlling the quantity of bank reserves than on tightly pegging the cost of those reserves (that is, the Federal funds rate). But the Fed was only partially successful in curbing money growth in the face of sharp changes in inflation expectations and wide fluctuations in credit demands. Some critics argue that this occurred because the Fed failed to apply its new operating procedures consistently. Probably a better explanation, however, is the continuation of heavy deficit-financing pressures.

A government deficit can be financed by attracting the savings of the public, or it can be financed by creating money. The latter approach is followed in most underdeveloped countries, because they lack fully-developed capital markets. But most industrial countries, with their highly developed financial markets, are able to channel private savings into purchases of government debt. In this respect, the U.S. has behaved like an underdeveloped country, whereas Germany and Japan have financed their large government deficits through private savings.

Our country, in other words, has failed to break the link between government debt and inflationary money creation as Germany and Japan have done. German and Japanese financial markets have succeeded better than ours in mobilizing private savings to finance government deficits. Over the course of the past decade, U.S. households sharply reduced their savings rate, from 7½ to 5½ percent of disposable income. In contrast, Japanese households consistently saved more than 20 percent of income, and their German counterparts saved between 12 and 15 percent of income. This divergence reflects differences in tax policy and differences in the way inflation affects savings incentives. Because of these differences, Americans have boosted consumption and reduced savings, and have discouraged productivity-enhancing business investment. Whatever the reason, we must reduce Federal deficit-financing pressures if we want to reduce inflation and encourage domestic saving and investment.

The President's new fiscal program represents an important step in the right direction. It includes personal-income tax cuts and accelerated depreciation write-offs designed to stimulate a

long-awaited improvement in productivity-enhancing investment. The program also includes a broad and judicious mixture of spending cuts designed to keep deficits from spiraling and creating even worse pressures on financial markets. The proposed cuts range across a wide range of programs, from food stamps to synthetic-fuel development, from extended unemployment compensation to the space-shuttle program, and from public-service jobs to postal subsidies.

Still, the Administration's budget proposals result in large fiscal deficits for the next three years, with no balanced budget in sight until 1984. For the 1981-82 period, the deficits add up to roughly $100 billion. This suggests that Federal demands in credit markets will continue for some time to press upward on borrowing costs — at a time when the Federal Reserve is committed to an anti-inflation objective of gradually and steadily reducing the growth in monetary stimulus.

Need for Spending Cutbacks

The necessity for substantial spending cutbacks in nondefense programs is obvious, given the Administration's commitment to a defense buildup coupled with tax reductions. Fiscal 1981 admittedly is almost half-over, but a running start seems necessary to achieve results in the next fiscal year. Incidentally, outlays for fiscal 1981 will exceed earlier estimates by a wide margin, mounting to $655 billion in the Administration's new estimate — $75 billion more than the fiscal-1980 figure and some $20 billion higher than the figure adopted in last fall's Congressional budget resolution.

In addition to cutbacks in business subsidies and other programs, Congress in coming budget debates will have to turn its attention to some

politically sensitive entitlement programs — "payments for individuals" — simply because that's where the money is. In the last fiscal year, such payments amounted to 70 percent of total outlays, aside from defense and interest payments. Entitlement programs increased eight-fold over the past decade and a half, and they accounted for virtually all of the real increase in budget spending recorded over that period.

The upsurge in these programs reflects the fact that roughly 90 percent of payments to individuals are now subject to indexation formulas. Indeed, this means further budgetary problems in the years ahead. According to Congressional Budget Office estimates, such payments could be $192 billion higher in 1985 than in 1980, with roughly three-fourths of that amount representing the cost of automatic escalation. The problem is compounded by the choice of an inappropriate index — the consumer price index, which has overstated inflation recently by virtue of the heavy weight it gives to mortgage interest rates and home prices. (Certainly it's inappropriate for those many recipients who reside in rented quarters or paid-up homes). Indexing will be expensive in any case, but a single reform designed to adjust for this overweighting could save $30 billion over the 1980-85 period alone.

Several uncertainties still surround the new Administration's program. The full details of the budget-cut proposals won't be sent to Congress until March 10. In addition, the budget proposals are still just that, since they must still run the Congressional gauntlet. The shape of the final budget package — specifically, the Federal government's actual financing needs — will determine the pressures the Federal government will place on the financial markets and the environment in which the Fed will have to conduct monetary policy.

Monetary Implications

Failure to curb Federal deficit spending will have dire consequences — crowding out private borrowers if the Fed holds to its policy goals, or leading to spiraling inflation if the Fed loosens up and accommodates the Treasury's borrowing needs. At present, when efforts to restrain monetary growth confront strong private credit demands, large new Federal borrowings would inevitably aggravate interest-rate pressures. Total Federal and Federally-assisted borrowing in the nation's credit markets reached $120 billion last year — more than 34 percent of all credit demands — and comparable figures may again be seen in the present period of strengthening credit demands. Indeed, the Treasury will need to raise $36 billion of new money in the present quarter alone — one-third more than in the year-ago period.

In this difficult situation, the Federal Reserve has no choice except to continue with its policy of reducing money-supply growth gradually over time, to help the national economy return to a non-inflationary growth path. This was the gist of the message provided by Chairman Volcker in his Congressional appearances yesterday and the day before. As he noted, the Fed has set a target growth range of 3½ to 6 percent this year in the M-1B measure of the money supply, compared with the 6¾-percent growth in that aggregate over the past year — all abstracting from shifts that will be caused by the growth of NOW accounts. M-1B, incidentally, consists primarily of currency and transaction (check-type) deposits at depository institutions.

The credit demands of the Federal government, the nation's prime borrower, definitely will be met. The question is how many other potential borrowers — many with more productive uses of money — will be shouldered aside by market

pressures. In that situation, there's a danger that the Fed's restraints on money and credit creation will jeopardize future prospects for business expansion and private job creation. But consider the alternative. If we did not restrain money growth, we could contribute to an inflationary process that would lead to a prolonged period of soaring interest rates.

Concluding Remarks

To sum up, the thrift industry at this juncture faces a difficult earnings situation, with its high-cost liability structure and its overhang of low-yielding mortgages. Over the long run, deregulation will help cure that situation, providing the industry with an opportunity to reduce its reliance on the volatile housing industry, as well as an opportunity to compete more effectively for funds in the open market. But the industry's basic problems can never be overcome without an attack on high inflation and high interest rates.

The Federal Reserve and the thrift industry have a vital stake in working together to overcome inflation. We should realize, first of all, that the Fed can do very little to reduce the cost of thrift-industry funds without first reducing the growth of the money supply, as a necessary step in reducing the rate of inflation and hence the levels of interest rates. We should realize, also, that any Fed attempt to reduce money growth without parallel reductions in Treasury financing demands could lead to severe pressures in financial markets. All of us, in a word, have a major stake in restoring the health of our financial markets by reducing the Federal government's heavy financing demands — because only in that way can we reduce the inflationary pressures created by excessive money creation. I look forward to working with you in the pursuit of this goal, which is so necessary to the achievement of a stable non-inflationary economy.