MUTUAL SAVINGS BANKS IN A CHANGING FINANCIAL ENVIRONMENT

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I am pleased to be able to participate today in this meeting of the National Association of Mutual Savings Banks. The challenges and opportunities confronting the savings bank industry at the present time are in many major respects the same as those facing the Federal Reserve. Like savings bankers, we at the Fed are attempting to deal effectively with difficult economic pressures of a cyclical nature in an environment of important secular change in the character of financial institutions and markets.

The most urgent challenge facing the nation today is that of inflation. The accelerated advance of prices poses a grave threat to the continued vitality of our economy, to the health of our financial institutions, and to the stability of the international system of trade and finance.

There is no "quick fix" for the problem of inflation. The origins of the current pressures on wages and prices can be traced back more than a decade to the early stages of the Vietnam War. At that time we failed to raise the tax revenues necessary to pay for increased military outlays and as a result, excessive aggregate demand produced the first burst of inflation. In subsequent years, we suffered a series of cyclical swings in which our short-sighted impatience to restore high levels of economic activity resulted in fiscal and monetary excesses and successively higher rates of inflation. And, of course, in 1974 we suffered the aggravating effects of a quadrupling of world oil prices. As a consequence of this history, expectations of inflation have become deeply ingrained in our economy and imparted a powerful momentum to the advance of prices.

The Federal Reserve has recognized the need to avoid the overly stimulative policies of the past. As this year began, the economy still was characterized by an appreciable degree of slack in labor markets and industrial capacity. However, we knew that continued expansion at the pace of earlier stages in the cyclical upswing would quickly use up that slack and seriously intensify inflationary pressures. Consequently, we have pursued a policy of measured restraint, intended to promote sustainable economic growth while helping to slow gradually the pace of price increase.

We have in fact seen moderation of economic expansion this year, with real gross national product rising at about a 4 per cent annual rate through the first 3 quarters versus 5-1/2 per cent in 1977. Although sizable gains in employment have been achieved, general levels of resource utilization that would have given further impetus to inflation have not been surpassed. Nonetheless, the rate of inflation has picked up markedly this year. A number of factors have contributed to this acceleration. A disappointingly sluggish performance of labor productivity has resulted in a more rapid rise of unit labor costs. These cost pressures have been exacerbated by Federally mandated increases in the minimum wage and in employer contributions for social security and unemployment insurance. Food prices have sky-rocketed. And to these domestic factors has been added the inflationary impact of the depreciation of the dollar in foreign exchange markets, which has raised import prices and weakened competitive restraints on domestic producers.

With the margin of unutilized productive capacity now further reduced, and a heavy schedule of collective bargaining slated for 1979, the danger of an escalation of wage-price pressures in the months ahead cannot be overlooked. There clearly is an urgent need to marshal the forces of public policy and private action to restrain inflation. While monetary policy has an important role to play, it cannot do the job alone. President Carter's recently announced anti-inflation program is therefore welcome. That program includes a commitment to greater fiscal restraint through the containment of Federal spending. At the same time, the program's wage-price guidelines establish realistic standards for constructive behavior on the part of labor and management. By providing an opportunity to break out of the destructive pattern of wages chasing prices, and prices chasing wages, these guidelines can contribute to a moderation of inflationary forces. Finally, the President's commitment to regulatory reform is also encouraging, for it points the way toward an enhancement of price competition and a reduction in needlessly costly regulation.

The Administration's anti-inflation program has been further fortified by recent joint actions of the Treasury and Federal Reserve, including a tightening of domestic credit conditions and the mobilization of $30 billion in key foreign currencies to help strengthen the dollar in exchange markets. The rise in the international exchange value of the dollar since the announcement on November 1 has been most heartening, and indicates that progress is being made in bolstering confidence here and abroad in our ability to achieve our economic goals.

The November 1 actions were consistent with the progressively less accommodative monetary policy that the Federal Reserve has pursued this year. In an environment of heightened inflation expectations, borrowers have been willing to pay higher rates of interest in order to obtain credit. To have held down nominal rates of interest in such a circumstance would have invited a credit-financed surge in aggregate demand and added further to inflationary pressures. Consequently, the Federal Reserve has permitted market rates to rise appreciably this year. Despite the rise in rates, however, there has been nothing approaching a general "credit crunch," as credit has remained in adequate supply to finance a volume of spending that is appropriate in light of the availability of real resources in the economy.

Historically, the relative burden of higher interest rates has fallen heavily upon the housing sector. This, in a sense, is inevitable, for houses are long-lived capital goods whose values are highly sensitive to changes in interest rates. Moreover, as with other consumer durables, the purchase of a home tends to be a postponable expenditure. However, the severity of the impact of monetary restraint upon housing was often compounded by government regulations that distorted flows of funds and curtailed the availability of mortgage financing. Thrift institutions, the leading suppliers of home mortgage credit, were subject to deposit interest rate ceilings that left them vulnerable to disintermediation whenever open market interest rates reached higher levels.

Predictably, as market interest rates climbed during the latter part of 1977 and in the early months of 1978, deposit growth at mutual savings banks and savings and loan associations slowed markedly. Rather than again forcing the housing sector to bear a disproportionate burden of monetary restraint, the Federal regulatory agencies authorized two new accounts in June: an eight-year certificate yielding up to 8 per cent at thrift institutions and a six-month savings certificate whose ceiling rate varies weekly with the 6-month Treasury bill rate. These new deposits were expected to enable thrift institutions to compete more effectively against open market instruments for lendable funds.

The six-month money market certificate has been especially successful in this regard, and deposit growth at both mutual savings banks and savings and loan associations has rebounded since June, despite further rises in market rates of interest. This stands in stark contrast to the experience of 1973-74 when market interest rates in the current range had a severe impact upon deposit growth. Although it is true that flows into the money market certificate to a large extent have been transfers from other accounts, it should be remembered that the savings institutions have been able to retain these funds, rather than losing them to the securities markets. The stronger deposit inflows have enabled thrift institutions to rebuild their liquid asset holdings, to reduce their pace of borrowing, and to increase their mortgage loan commitments.

The primary concern with the money market certificate voiced by mutual savings bank executives appears to be with the increased cost of the funds brought about when a depositor transfers his balance from a lower-yielding account into a certificate. This increased cost of funds likely will cause some deterioration in mutual savings bank earnings over the short run. However, mutual savings bank profitability has grown steadily over the past three years, with earnings relative to assets reaching near-record levels during the first half of 1978. Thus, although the cost of the certificates may cause difficulty for some banks whose earnings and capital positions are well below average, the industry as a whole appears well able to absorb a moderate decline in profitability. Also, to the extent that funds attracted by the certificates allow savings banks to book additional mortgage loans at present attractive rates, long-term profitability should actually be enhanced by the increased access to funds provided by the certificates.

This opportunity for greater long-term profits unfortunately is to an extent limited in those states that impose mortgage usury ceilings that are unrealistically low in relation to present market interest rates. Such ceilings, as you are well aware, inhibit the ability of a savings bank to compete effectively for deposits and thereby curtail the availability of mortgage credit; in the end, the ceilings harm the consumers they are intended to protect. There can be little doubt that the elimination of these obstacles to the flow of capital would serve not only to enhance the efficiency of our financial system but also to bring greater stability to the home-building industry. One hopes that the current shortages of credit that usury ceilings have brought to numerous local mortgage markets will prompt legislators to rewrite the laws that can only be detrimental to the economic development of their states.

Viewed in a broader perspective, the creation of the money market certificate represents another step in the evolution of our financial markets. There have been dramatic changes in recent years as private institutions have responded to changing technology and the growing sophistication of their customers. At the same time government has endeavored to shape a financial structure that fosters through competition the efficient allocation of capital. Mutual savings banks have been active participants in this process, as they have throughout their history.

Indeed, the establishment of the savings bank industry in America over a century and a half ago was a creative response to the needs of an emerging wage-earning class in the early commercial centers of the Northeast. Ignored by the commercial banks of the early 1800's, these small savers turned to the newly formed MSBs as an investment outlet. By building an unsurpassed record of safety for their depositors, mutual savings banks grew to be the dominant private thrift medium in many of the states where they were chartered. Investment patterns by the savings banks were adjusted from time to time in response to shifts in the financing needs of the economy. For example, after helping to finance wartime Government budget deficits, the savings banks then helped fund the post-World War II housing boom as the major mortgage lender in many localities.

Changes in the economic environment in which savings banks and other thrift institutions operate have been especially dramatic in recent years. The financial portfolios of households have grown and the secular uptrend in interest rates has increased the potential rewards of careful asset management. The competition for funds has become more intense. This has become more noticeable with each successive period of cyclical credit stringency. Individual savers have become more attuned to the opportunities for investment in market instruments, which at such times have offered yields in excess of those on small denomination deposits. Furthermore, nondepositary intermediaries such as money market mutual funds have increasingly provided smaller savers with a vehicle for pooling risks and earning market interest rates.

In order to maintain their access to loanable funds, thrift institutions have had to offer a broader variety of liabilities at more attractive yields. Whereas not very long ago many thrift institutions issued only passbook savings accounts, today they offer a menu of instruments that includes time certificates, I.R.A. and Keogh accounts, demand deposits and N.O.W. accounts. The competitive forces that have prompted these developments have been abetted by the progressive liberalization of regulatory and statutory restraints.

This process must continue. We need to move gradually toward the ultimate elimination of artificial barriers to competition in our financial markets. The system of deposit rate ceilings--including the distinction between commercial banks and thrift institutions--distorts credit allocation and discriminates against the saver of smaller means and limited sophistication.

Of course, if thrift institutions are to be able to function successfully in the increasingly free and competitive environment I am advocating, there will have to be some adjustments in their asset powers. The elimination of usury ceilings I mentioned earlier is just a first step--albeit an important one. Another step that would appear worthy of careful consideration is authorization of variable rate mortgages. These instruments might help to alleviate the cash flow problems that thrift institutions experience during cyclical upswings in market interest rates as a result of the imbalance between asset and liability maturities. The experience of those few savings banks that have introduced VRM's--as well as that of institutions in California where they are widely used--suggests that, with adequate safeguards, these instruments could find broad consumer acceptance.

But VRM's need not be the only alternative to the standard mortgage instrument. Restrictions on credit arrangements should be more generally relaxed, so as to permit borrowers and lenders to establish the mortgage contracts that best serve their needs in a changing financial environment.

Consideration should also be given to the possibility of broadening the consumer lending powers of thrift institutions in those states where restrictive laws still exist. Besides permitting them to serve better the needs of their customers and enhancing competition in the credit market, the ability to make consumer loans would also provide thrift institutions with a means to moderate the cyclical earning pressures that limit their ability to offer competitive deposit rates.

It might be noted that one likely consequence of the changes that have occurred already in the thrift industry and of those that may occur in the future would be a new relationship with the Federal Reserve. The Federal Reserve is continuing to consider proposals that would promote equity among competing financial institutions and assure continued effective monetary control. Such proposals might include authorization for the Federal Reserve to impose reserve requirements on transactions balances at all depositary institutions, while giving them access to the discount window and other Federal Reserve services. We are currently developing pricing policies for these other services; a tentative price schedule that would apply to all users of the Federal Reserve's payments mechanism was recently made public and transmitted to Congress.

As I look to the future, a lessening of the competitive challenges facing mutual savings banks is not on the horizon. The marketplace is exerting irresistible forces for change; the continued vitality of the savings bank industry will depend on your ability to find means of meeting the needs of your communities in creative and efficient ways.