The Challenge of the Boom*

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It is again a pleasure for us in the Federal Reserve System to meet with you, the members of the New Jersey Bankers Association, and to share our thoughts on matters of mutual concern. I propose to discuss with you today some current challenges to the attainment of our national economic goals of growth, employment, price stability, and equilibrium in international payments.

HALF DECADE OF ECONOMIC DEVELOPMENTS

We are now in the sixth year of continued economic expansion, and the tempo is strong. We have seen a growth in gross national product of over 5½ per cent per annum in real terms, a reduction in the rate of unemployment to below the 4 per cent interim unemployment target set by the Council of Economic Advisers in 1961,[1] and relatively stable prices during most of the period. This achievement was promoted by a mutually reinforcing combination of fiscal policy and monetary policy.

DISTURBING FACTORS. But there are also disturbing factors, such as the general increase in prices which has begun to erode our relatively good price record of recent years, and the severe deficit in our international balance of payments which has persisted over most of the last decade.

CURRENT ECONOMIC SCENE

Economic activity in the first four and a half months of 1966 has been booming. In the first quarter, gross national product rose at an exceptionally rapid pace. The gain in real terms was large, but more than one third of the dollar increase represented higher prices.

The newspapers remind us daily of the cost of the war in Vietnam and of other military needs. But spending at all levels of government for other purposes is also high—indeed at record levels; and the same is true for consumers and businessmen.

It appears that these high rates of spending by the various segments of our economy will continue. This conclusion is supported by recent surveys of consumers' buying intentions and of businessmen's plans for spending on capital and equipment, and by the outlook for large spending by government at all levels.

BANK CREDIT. As bankers, you know at firsthand that business loan demand continues very strong. Bank credit is expanding rapidly, after having slowed down somewhat in February. So far in 1966, bank credit has been growing at very nearly the exceptionally high rate of 1965; and this expansion is taking place despite the increased pressure of monetary policy and higher interest rates.

BALANCE OF PAYMENTS. With the aid of the voluntary restraint program, the flow of capital funds abroad was reduced substantially in 1965, with the result that the balance-of-payments deficit for 1965 was $1.3 billion, compared with an average annual deficit of $2½ billion during the preceding four years. Fortunately, our exports have exceeded our imports for many years; last year the excess was about $4.8 billion. Thus our favorable trade balance has offset part of the drains caused by military and

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[1] "In 1961, the Council set as an 'interim target' a 4 per cent unemployment rate—as a level that could safely be achieved by measures of demand expansion alone. At that time the Council noted that effective measures to improve the training and mobility of the labor force might safely permit a lower target. It also noted that the degree of inflationary pressures that would be associated with any given unemployment rate depends as well on the extent of internal balance—among economic sectors, industries, and regions. . . ." Remarks of Council Chairman Gardner Ackley on *The Businessman's Role in Fighting Inflation* at the fifty-fourth annual meeting of the Chamber of Commerce of the United States, May 2, 1966.

foreign aid payments, capital movements, and other payments.

Despite a welcome rise in exports so far in 1966, the growth in our imports has exceeded the gain in exports. And we have just learned that our balance-of-payments deficit in the first quarter of 1966 (expressed at a seasonally adjusted annual rate) has deteriorated from the year 1965. If we have further increases in costs and prices at home, it will be even harder for American products to compete in foreign markets. At the same time, with high demand for goods at home and increases in prices in the United States, Americans are likely to buy many more imported goods. Thus, it is easy to visualize the possibility of a worsening of our adverse balance-of-payments position.

INFLATION

In a setting of rapidly expanding business activity, increased demand for and use of credit, declining unemployment, shortages of skilled labor, and increased production bottlenecks, pressures on prices have been mounting. With an already high utilization of resources, a high aggregate demand for goods and services is pressing on a limited supply. Inflation is a clear and present danger. Relatively mild action, if taken in time, may suffice to bring inflationary pressures under control in their early stages. Delay may induce economic distortions that require stronger and more painful action later on.

Inflation adversely affects everyone. In combating it, there should be concerted effort by all—by Government, by labor, by businessmen, by bankers—to protect the value of the dollar.

GOVERNMENT INFLUENCE

The United States Government has two principal instruments of general and indirect application that influence the overall demand for goods and services; these instruments are fiscal policy and monetary policy. By the use of such instruments to prevent demand from increasing too rapidly, opportunity is afforded the market mechanism to assist in equating the demand for goods and services with the supply at reasonably stable prices. Over the last half decade fiscal policy and monetary policy worked together to promote our national goals of economic growth and employment.

MONETARY POLICY. In the earlier portion of the period an expansionary policy on the part of the Federal Reserve brought about the creation of substantial additional reserves for member banks, and thus allowed the banking system to expand deposits and credit greatly. For balance-of-payments reasons, however, short-term interest rates were prevented from declining to the extremely low levels they had reached in periods of expansionary policy in the 1950's.

In the latter part of the recent period, monetary policy, while still providing for growth, gradually shifted from ease to restraint. Through open market operations the Federal Reserve refrained from creating sufficient reserves to accommodate all the increased demands for credit at unchanged interest rates. The increase in the discount rate from 4 per cent to 4½ per cent in December was a further step in a policy to deal with the excessively rapid rate of credit expansion and with developing inflationary pressures.

In 1966 the Federal Reserve has been gradually increasing the degree of restraint in the creation of bank reserves. You may expect that in the present economic setting the Federal Reserve will not supply sufficient reserves to enable the banks to make all the loans requested of them by borrowers of good credit risk; if the Federal Reserve were to supply such reserves it would be adding fuel to the fires of inflation.

FISCAL POLICY. In 1961-65 fiscal policy was deliberately expansionary, boosting consumer and business purchasing power. Through liberalized depreciation allowances, an investment tax credit, and a large tax cut in a period of a budgetary deficit, fiscal policy demonstrated its usefulness in speeding a recovery. Fiscal policy can be a double-edged tool—one that is effective in checking a boom as well as in promoting expansion.

Through the Tax Adjustment Act[2] enacted two months ago, fiscal policy has already begun to contribute to the dampening of overall demand, by raising certain excise taxes, increasing the withholding on individual income taxes, and speeding up the payment of corporate income taxes. Nevertheless, the Federal Government is still providing a considerable fiscal stimulus in a setting marked by excess demand.

The Joint Economic Committee of Congress has expressed its concern about inflation and has urged fiscal action to combat it. The majority stresses increased taxes; the minority stresses reduced spending. A combination of both would seem helpful. It may not be realistic, however, to expect large cutbacks in spending. Many informed observers have expressed the view that the announcement of a proposal for an increase in Federal income taxes

[2] Tax Adjustment Act of 1966, Pub. L. 89-368 (March 15, 1966).

would immediately dampen inflationary psychology, that the enactment of the increase would promptly reduce overall demand, and that the action could be reversed with minimum delay if developing events were to counsel a reversal.

No doubt, all of us have heard a variety of suggestions as to the appropriate characteristics of a tax increase. Perhaps the most important requirement would be simplicity, which would encourage consideration and enactment without undue delay. Recognizing that the Administration and the Congress have the responsibility for working out together the terms of any tax legislation, I would think that characteristics such as the following merit careful consideration:

(1) that the increase be temporary, designed to deal with a temporary situation and not to provide a permanent boost to Federal revenue;
(2) that the incidence of the increase on taxpayers be as neutral as possible; and
(3) that the increase be large enough to blunt inflationary pressures, but not so large as to jeopardize continuing expansion of economic activity within the capabilities of available resources.

It seems to me that the prompt announcement and enactment of a suitable tax program would help to maintain an orderly and balanced economy now, and would contribute over the long run to sustainable economic growth and the expansion of employment. More fiscal restraint would, of course, lessen the need to place too great an anti-inflationary burden on monetary policy, and would reduce the inevitable pressure on interest rates.

ROAD AHEAD FOR BANKS

In the present economic setting, bank credit cannot be permitted to expand at as rapid a rate as it has in recent years. As I indicated earlier, you may expect that the Federal Reserve will not supply sufficient reserves to enable the banks to make all the loans requested of them by borrowers of good credit risk. This does not mean that the Federal Reserve wants to bring bank credit expansion to a halt; it wants to moderate the pace of the expansion so that the overall economic advance can be sustained.

Even with the most appropriate Governmental policies and with self-restraint on the part of participants in the private sector of the economy, the road ahead for banks will not be easy. The individual bank will have at least two very important problems: (1) determination of the loans it will make, and (2) determination of how it will meet temporary or perhaps more lasting deposit losses.

POLICY ON LENDING. The individual bank will probably not be able to make all the loans it would like to make. In other words, a bank must be selective; and ability of a prospective borrower to repay the loan cannot be the only test of selectivity. Higher rates of interest charged on those loans that a bank is not anxious to make is a traditional method of discouraging borrowing. But rationing through rate alone cannot be the determining factor. In many cases, a bank will probably find it necessary to apply some order of priorities.

Yesterday the President of the American Bankers Association gave some advice on the banker's role in reinforcing monetary policy. At the Annual Convention of the Arkansas Bankers Association, he said:[3]

> All of us on the firing line in bank lending operations know that today there is simply not enough money available to meet all loan demands—that many of the requests which must be turned down are not marginal applications, but are from good customers who need to finance sound projects. The hard fact is that we must select; we must allocate—and we need to do so on the basis of logical and equitable principles that will serve both the needs of our customers and the economy.

Emphasizing that no set of rules can apply to all institutions, he asked bankers to consider carefully ten questions developed as general criteria by a subcommittee of the Association's Banking and Financial Research Committee. I commend the ABA for its constructive advice to the bankers of the country.

Of course, no set of questions and no statement of policy, priorities, or guidelines on lending can be a substitute for proper monetary policy. Nor could any domestic voluntary credit restraint program, whether formal or informal, be a substitute for adequate monetary and fiscal policies; moreover, such a program would eventually fail without support from a general restriction on credit creation by the Federal Reserve. But with adequate monetary and fiscal policies, in an environment in which the demand for credit is high, some order of priorities is an indispensable tool for an individual banker as he makes his day-to-day decisions in response to requests for credit by specific customers.

BANK LIQUIDITY AND TIME DEPOSITS. Now let's consider the bank's problem of meeting its liabilities. Loan-deposit

[3] Remarks of Archie K. Davis before Annual Convention of Arkansas Bankers Association, May 18, 1966, page 3.

ratios of banks are higher than they have been in decades. In order to meet the loan demand of customers, individual banks have reduced their liquid assets and increased their short-term liabilities. They have been running off investments at maturity and selling other securities in advance of maturity; as a result many banks now have fewer securities that they can readily liquidate than they have had in over a quarter century.

As one means of enlarging their loanable funds, banks have been aggressively seeking time deposits in the form of negotiable certificates of deposit and savings certificates. More than $17 billion of negotiable C/D's are now outstanding; business corporations are important holders of C/D's. Savings certificates and similar types of nonnegotiable instruments total more than $12 billion; individuals are of course the most important holders of such instruments, but many are also held by smaller businesses and institutions. The holders of negotiable certificates are highly rate conscious, and rates are also an important consideration for many of the holders of nonnegotiable instruments. The relationship of the rates on certificates and similar instruments to the rates on other comparable investment media is closely watched by such investors.

Mindful of the rate consciousness of such holders and of the strong demand for loans, some banks that have issued large amounts of certificates have been inclined to raise the rates of interest on their certificates in order to assure themselves against a runoff of the certificates and to pick up some additional deposits. As competing banks have taken similar steps, the rates on certificates have ratcheted upward. The result has been an increased cost of money to the banks without materially affecting the volume of deposits in the banking system as a whole. This upward ratcheting of rates on certificates has in turn tended to push up the rates on other investment media. As the President of the American Bankers Association pointed out yesterday, "Even though sound competition for savings can benefit all involved, unsound and unbridled competition, coupled with an upward spiraling of interest rates, can result only in trouble for banks, for their competitors, and for the financial structure and the economy."[4]

[4] Remarks of Archie K. Davis before Annual Convention of Arkansas Bankers Association, May 18, 1966, pages 6 and 7.

What would happen if a significant number of holders of C/D's or similar instruments were to decide not to renew or replace maturing certificates and other persons did not buy new certificates? Perhaps a holder decides to use the proceeds for business purposes or for the acquisition of another investment. The fact that the banking system as a whole may not experience a reduction in overall deposits is likely to be small comfort to the individual banker who sees his certificates of deposit declining with a consequent reduction in his total deposits and a loss of reserves to other banks.

The problem of the aggregate reserve needs of the banking system is, of course, the primary responsibility of the Federal Reserve. The problem of the reserve and liquidity requirements of an individual bank, however, is the primary responsibility of the bank's management. Now is the time for each banker to scrutinize carefully his liquidity needs, his ability to maintain his deposits, and his reserve needs to support his deposits. He must guard against the temptation to sacrifice too much liquidity in order to increase earning power; in the long run, it may turn out that a relatively modest increase in earnings has been purchased at too high a cost—a cost incurred through adjustments later forced upon the bank because a low cushion of liquid assets turned out to be inadequate to meet losses of interest-sensitive deposits.

CONCLUSION

In summary, total demands on the economy are outrunning real resources. Inflationary pressures threaten the attainment of our economic goals. Monetary policy and fiscal policy are called upon to exert their complementary influences to dampen those pressures. Banks have already felt the effects of a monetary policy that has involved an increasing degree of restraint. Looking to the future, the best way to avoid the ills of inflation is to fight the inflation promptly, and the best way to fight a recession is to fight the inflation that customarily precedes and helps to bring about a recession.

Each individual banker must determine for himself, in the light of overall considerations, what loans he should make and what steps he should take in the conduct of his bank's affairs, to assure that there is never any question of the ability of his bank to serve the public interest, and to protect the interests of his customers, his depositors, and his stockholders.