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Economic Growth and the Banking Structure

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ECONOMIC GROWTH AND THE BANKING STRUCTURE

Throughout most of our nation's history, economic growth, like youth, has been taken for granted. But unlike the aging man who can only fail to regain his youth, the social-economic organism can be conditioned for growth, stagnation, or decline with appropriate political policies.

Whether economic growth became a national goal and policy aim because it was something that could no longer be taken for granted or for some other reason is a topic we might speculate about for the full time you have allotted me. I take it to be the fact, in any case, and content myself with observing that growth is not really the thing sought but is a derivative from other goals. It is derived from the argument that rapid economic growth facilitates the achievement of widely sought social and personal goals such as: increasing leisure, a basis for our "aspirations to consume," employment for a growing labor force, and the projection of the image of a free society to the world. We might add that with these goals goes the accompanying hope that growth will somehow improve the quality of society and not induce a malaise from too much devotion to la dolce vita.

Within the economy, growth is no less desired by private business firms, the components of our capitalist engine. They, too, have in mind specific objectives associated with corporate growth; rising prestige, diversification of products and markets, long life, if not immortality stability of profits, and sheer power. Indeed the modern U.S. corporation might best be thought of not as a unit designed in the image of a product or service but rather as an abstract capacity to produce. Managers and owners of these firms are alert to direct and expand this capacity wherever profit opportunities, generated by growth and change in the economy, appear.

They are highly flexible; their genius is in the ability to organize production and exploit markets.

Banks in some respects share their attributes. As lenders they are par excellence "units of capacity to produce"; their great flexibility of decision is apparent in the variety of alternative loans and investments available to them. Like their counterparts in business firms, bankers shift and expand their capacity wherever profit opportunities, created by growth and change, present themselves. But it must not be overlooked that in amassing the resources to lend and invest banks may be unable to break away from their physical locations. The freedom of adaptation they enjoy in their lending activity is unmatched by freedom to follow depositors and savers when they move from the city to the suburbs or from the farm to an urban area.

As our economy has grown, specialized and incorporated technological change in production and distribution, the banking system has come under increasing pressure to adapt. Rather than attempt to list all the forces at work that seem relevant--and are readily translatable into entrepreneurial incentives of prestige, profit and power--I shall deal with three: population growth and movement, evolution in data processing technology, and the increasing importance of nonbank financial institutions. After examining the nature of these changes, I will turn to some of the implications for public policy of alternative changes in banking structure.

Looking backward, the most pervasive economic influence on banking structure has been the differential nature of population growth and movement. Beginning with World War II, population changes have had an enormous impact on banking structure.

For example, in this period farm population shrank at least one-third, the population of the core cities in many of our metropolitan areas declined and the growth in population in the West and certain Southern states was 2 to 4 times what it was in the East and North Central states. These changes differentially affected banking structure. In many rural areas growth and profit prospects dimmed and the banking structure became static. The banks in the core cities without the legal sanction to branch and follow their customers into the suburban periphery saw their positions shrink relative to banks in states where branching was permitted.

If we examine the banking statistics by states, we find that in the 31 jurisdictions where the population increase during the decade was less than average for the United States (18 per cent), there were 20 widely scattered states in which the number of banks changed hardly at all. (I am not here speaking of banking offices) In 9 of the 31 states there were reductions of 20 to 35 per cent in the number of banks as a result of substantial consolidation activity. In only two of the 31 states were there increases; one of 8 and one of 10 per cent.

In the 20 states where population increased more than the U.S. average there was only one state in which the change in number of banks was nominal. In six of the faster growing states there were increases in number of banks of 8, 11, 14, 22, 33, and 49 per cent. In 13 states there were declines of 8 to 45 per cent as branching, mergers and consolidations offset the impact of the expanding population on bank numbers.

These data indicate that the population movements of the past two decades have had a major impact on banking structure. They expose the vulnerability of locally-based financial institutions to population migration.

Unable to follow individual depositors and savers to their new locations and substantially handicapped in servicing nonlocal business customers the unit bank or any other local financial institution is more or less chained to the future of its home community. How damaging this may be to their economic welfare depends quite obviously on the community in question and the confinement enforced by state law.

Another more recent change which augurs adaptation by the banking system is the revolution now taking place in business communication and data processing. Much thought and study is currently being given to the implication of such techniques on bank costs and services to customers. On the face of it, it would appear that electronics is the genii of the large bank and cannot be put to work with as great an advantage for the moderate sized or small bank. But it is too soon to conclude that EDP cannot be adapted or made available to smaller institutions or that competitive costs cannot be substantially met by other accounting techniques.

A third change forcing adaptation by the banking system has been the rapid growth of nonbank financial institutions in the past two decades. Their growth has changed the competitive environment in which banks operate and is an increasing challenge to the primacy of banks as suppliers of credit to many sectors of the American economy. Not all savings accumulators are as geographically confined as are commercial banks. Sales and commercial finance companies go to the capital markets for funds and lend nationally. Insurance companies also gather funds across state lines and over metropolitan areas. Savings and loan associations and mutual savings banks tend to be confined by the same geographical limits as the commercial banks and are similarly handicapped by lack of local growth or out-migration. Whether the inertia of age and status or the confines of banking statutes, augmented by hobbling regulation, has made banks a pushover for a growing array of competitors has not been established. Indeed, it has not even been established that they are, in fact, a pushover.

In the framework of entrepreneurial incentives and statutory constraints bankers themselves must be adapting the structure of their industry to make it more profitable and more responsive to opportunities for growth. Public policy confronted with these efforts at adaptation must take into account the underlying and often complex changes in the economy that surround the industry. While it does not initiate changes, through the granting or withholding of approval for changes sought by the industry, it has a part in shaping the financial apparatus that serves the American economy.

The role of public policy, properly conceived, is the task of maintaining competition, of ensuring its strength and at the same time achieving maximum efficiency and productivity for the banking system and doing all of this without central direction of decision. This task is not a static one. If the deep and complex changes in the economy and the industry that are taking place are ignored or misunderstood, or if an attempt is made to apply concepts appropriate only to the past, public policy decisions will delay and deter evolutionary processes.

Maintaining competition comes up in many guises but consider as an example how banking facilities should be established in response to shifting deposit densities and changes in the structure of the demand for credit. Should it occur through building anew or by purchase of existing facilities in the growing area? If it is by merger, affiliation or common ownership, market control may be the dominate consideration. One bank sees that it can get a very high return on its investment by buying its competitors and having the market for itself. But merger can also occur as the cheapest form of expansion or adjustment to change. Banks may find that choosing the merger route to expansion, relocation or portfolio adjustment is a sensible procedure. It may be cheaper to buy than to build a trained staff and a developed deposit and loan business, even at a premium price. Moreover, an individiaul bank may be worth more as a component unit to, say, a holding company or a branching organization than to its present owners. Under these circumstances, a premium price is likely to persuade present owners to sell rather than depend on an uncertain return on their investment once a new bank or new banks enter the area.

What should the stance of public policy be in instances like these? Should it look to and attempt to sort out motives, rejecting those acquisitions aimed at market control? I think not, since it is seldom possible to distinguish and weigh motives that are intertwined and sometimes concealed. Then, too, there is no guarantee that the innocent motive today may not be the predatory motive of tomorrow.

It may be that the best course for public policy is a passive one, to accept mutations as being natural. If the trend is to size, perhaps the best course is to accept the inevitable and to encourage the choice of the cheapest and fastest way to achieve size. The rationale of this passive role would be that there are significant economies of size that arise in specialization of function and automation of processes. If, in fact, economies of size are present to a high degree in banking, attempts to stifle the growth of banks into affiliated and branch organizations may be as ill-conceived as the legislative attempts to stifle the growth of chain stores in the 20's and 30's.

Chain units could enjoy larger profits by volume distribution at low margins. Consumers of the products could get more for the same money or the same amount for a smaller proportion of their incomes. Both sellers and buyers were made better off.

Raising the question of the relation of the size of the bank to its efficiency in gathering up savings, servicing depositors and allocating credit to its most productive uses, forces us to raise the most difficult problem of all: understanding the relationship between the structure of markets and the level and movement of prices.

It is an illusion to associate the force of competition with the number of competitors. A market may possess a goodly number of seemingly independent sellers who do not compete because they all follow a leader. On the other hand, a market with only a few sellers may be one in which there is aggressive competitive downward revision of sales terms, and the passing on of productivity gains to customers.

The enormously difficult problems of finding out how big a bank has to be to be efficient enough, and how many banks are needed to maintain competition enough, are not problems that can be solved by armchair logic. I do not raise these problems to suggest that I have ready answers but rather to suggest that the authority charged with tussling with them will get more help by digging into empirical fact than in engaging in speculation.

Now, does all this add up to the demise of independent unit banks, an end to their usefulness as components of our banking system? Probably not. There is little in our present imperfect state of knowledge suggesting that economies of size are so pervasive that if all legal constraint were suddenly relaxed we would end up tomorrow or next year with something like

Canada's eleven commercial banks, Australia's seven, the United Kingdom's big five, France's big six, or Italy's big eight.

Main Street National may not be a growth firm but it may be entirely adequate to the community it serves. It may itself be too small to bear the charges of automating its accounts. But Main Street and 10 or 20 others like it may be able to do in service bureaus or in association what they cannot do alone.

Another reason why we should not expect to see the independent unit bank washed away on the crest of technology is that the major changes we have spoken of are highly structured geographically. In vast regions of the nation the local unit bank continues to provide services and facilities on terms and in locations that affiliates of city banks are not prepared to challenge. Even in urbanized areas and where branching systems proliferate the unit banker can, with a touch of ingenuity and the judgment he is known for, often more than hold his own.

It is sometimes alleged that the typical unit bank cannot compete with large branching systems because it cannot offer the same range of services.

The failure to recognize that a bank will only offer those services it pays it to offer lies behind what we might call "the fallacy of extension of services." The fallacy has several variations but its most common form goes something like this: public policy ought to accommodate mergers between a large and small bank because the large bank can offer the residents in the small bank's location a wider range of banking services. A little thought tells us that this is equivalent to arguing that the medical societies ought to rescind the licenses of general practitioners because they can't be specialists in every branch of medicine. Both the neighborhood banker and the family doctor recognize instances beyond their skill, seeking either specialized advice or referring the case when it is necessary.

To extend the illustration a bit, no one would argue that a manufacturer of paper clips ought to go out of business because he does not produce staples or rubber bands. Almost everyone would say that this manufacturer probably concentrates on paper clips rather than produce all three products because he finds it profitable to do so. It seems just as reasonable to assume that the neighborhood banker does not offer a very wide range of special services because the demand for them is too infrequent to pay him to acquire the staff competent to administer them. A neighborhood bank does neighborhood business, changing the ownership of the bank--the name over its door--won't change the nature of its business.

I have attempted to indicate that the task of maintaining competition is of sobering difficulty in concept and implementation. It would be much simpler to adopt a policy of maintaining <u>competitors</u> since this would offer a much clearer guideline and certainly is not out of keeping with the "theory of hostility to concentration of power in the hands of a few" expressed by our Founding Fathers. But the hazard in a policy of maintaining competitors is that it might literally become just that--and nothing more. In lieu of competitive performance we would be substituting havens which the rigors of competitive action could not penetrate.

There is every reason why public policy ought to be concerned with avoiding undue concentration of economic power. Where efficiency and dilution of economic power conflict, gains from efficiency even though clear and of significant proportions cannot be overriding. The important <u>caveat</u>

to enter here is that we accept the price involved in a structure of priorities where economic democracy has a higher rank than economic efficiency, just as we recognize and accept--indeed, insist upon accepting--the price of maintaining our sometimes "inefficient" democratic form of government.

CHANGES IN NUMBER OF BANKS, 1951 - 1960
RELATED TO CHANGES IN POPULATION, 1950 - 1960

Population increased by less than 18% and number of banks increased or decreased by --								
+ or -5%			-5% or more			+5% or more		
State	% Change		State	% Change		State	% Change	
	Bank	Pop.		Bank	Pop.		Bank	Pop.
Arkansas	+3.0	- 6	Kentucky	- 7.3	3	Alabama	+ 5.3	6
Georgia	+4.5	14	Massachusetts	- 5.0	9	Illinois	+ 7.9	15
Iowa	+1.5	5	Dist. of Col.	-36.8	- 4	Wyoming	+ 5.8	13
Kansas	-3.3	14	Idaho	-23.8	13	Montana	+10.0	14
Minnesota	+1.3	14	Maine	-25.4	6			
Mississippi	-4.5	0	New York	-35.1	13			
Missouri	+4.5	9	N. Carolina	-18.7	12			
Nebraska	+2.4	6	Oregon	-27.1	16			
New Hampshire	-1.3	13	Pennsylvania	-26.8	7			
North Dakota	+4.0	2	Rhode Island	-35.7	8			
Oklahoma	+1.0	4	Vermont	-18.8	3			
South Carolina	-2.7	12						
South Dakota	+3.0	4						
Tennessee	-0.3	8						
Wisconsin	+1.1	15						
W. Virginia	+0.6	- 7						

Population increased by 18% or more and number of banks increased or decreased by --								
+ or -5%			-5% or more			+5% or more		
State	% Change		State	% Change		State	% Change	
	Bank	Pop.		Bank	Pop.		Bank	Pop.
Virginia	-3.2	+19	Alaska	-35.0	75	New Mexico	+ 7.8	39
			Arizona	-23.1	73	Colorado	+22.3	32
			California	-41.8	48	Florida	+48.6	78
			Connecticut	-37.5	26	Hawaii	+33.3	26
			Delaware	-44.4	40	Louisiana	+14.5	21
			Indiana	- 7.9	18	Texas	+10.6	24
			Maryland	-16.9	32			
			Michigan	-12.6	22			
			Nevada	-12.5	78			
			New Jersey	-20.4	25			
			Ohio	-10.8	22			
			Utah	- 7.4	29			
			Washington	-25.6	19			