BANKING AND ECONOMIC PROGRESS

Address
by
Delos C. Johns
President, Federal Reserve Bank of St. Louis

Before the
Seventy-first Annual Convention of the
Missouri Bankers Association
Hotel Muehlebach, Kansas City, Missouri
Tuesday, May 16, 1961

BANKING AND ECONOMIC PROGRESS

If you have thought a moment about the subject selected for the discussion to be presented in the next few minutes, it may have occurred to you to wonder whether I propose to attack the subject on the banking flank or on the economic progress flank. Both possibilities have their attractions. If the objective were to capture the audience's favor by flattery, one might allege and set about proving that without progressive and efficient banking there will be no satisfactory economic progress. Most of us do not recoil when told how important we are. On the other hand, if the objective were only to emphasize the virtual certainty and unquestioned importance of economic progress as a national goal, an argument could be made that as a matter of self interest banking must maximize its contribution to economic progress. The two ideas are not separate; the difference between them, if any, is one of emphasis. Therefore, let us attack on both flanks, viewing banking in two ways: (1) as an industry producing and selling services in a progressing national economy; (2) as a career opportunity for men and women of integrity, intelligence, resourcefulness, ambition, and the will to work. Let me emphasize this point: I shall be talking most of the time about banking as an industry, not about particular institutions.

It seems to me that there is an old stereotype of banking which we need to examine as a point of beginning. There seems to be an impression in some quarters, in and out of banking, that banking is a kind of static industry, without encouraging evidence of growth and development in the past,

and without satisfactory prospect for the future. This morbid impression is exemplified, I think, by often-heard complaints that it is hard to attract bank capital, and by another, and perhaps more frequent, complaint that it is hard to attract promising young people to banking as a career. Let us compare that old stereotype with the contemporary image of banking as an industry. Special situations in particular banking institutions, I repeat, are not part of this examination. We shall inquire how banking compares with other industries in value of services produced, for example, in agriculture, manufacturing, and insurance. We shall inquire whether banking's growth, in terms of services produced, has been slower or faster than the average for the nation. We shall inquire what there is in the nature of the services banking produces and sells that contributes to understanding of past performance and offers clues to the future. Thus we shall work back and forth between the two flanks of our subject: what we know about banking, and what we know or believe about a progressing national economy.

It may strike you as queer to ask first what the products of the banking industry are. You know what they are. For purposes of analysis and exposition, however, it is necessary to begin with fundamentals, even as football coaches have to begin with fundamentals. Let us group the products of the banking industry, for the purposes of this discussion, into three classifications. First, banking furnishes the means by which multifarious and, I will say countless, transactions in our market economy

are consummated. We don't know what proportion of all market transactions is completed on the books of banks, but we know the proportion is large and probably increasing. I have heard and seen it estimated at more than ninety per cent, which I would guess is not exaggerated. Making the proper entries, keeping things straight, and doing all the varied things required in that connection make up a truly enormous, and enormously important, service produced by the commercial banking system. And let me interpose one small claim: the Federal Reserve has a part in it. This banking service of which I am speaking can be easily overlooked by the general public, because so much of the work is done behind the scenes. The public sees and has personal dealings with tellers and lending officers, for example, but we know, if we count heads, that most members of bank staffs are back in the work rooms, bookkeeping, transit, and so forth, busily carrying out the wishes and orders of customers. As a quick means of appraising the importance of this classification of banking service, i. e., consummating transactions, consider for a moment what the consequences would be if all the bookkeeping and proof machines in all the banks of the country were to break down today and remain inoperative for a while. As a certain comedian used to say, "Perish forbid." The American economy would slow to a crawl.

A second general class of the products of banking consists of services rendered in the channeling of savings into investment. Traditionally, the banking industry has made available to qualified borrowers the idle funds of other people, safeguarding, of course, depositors' funds that have been

entrusted to it. In doing this, banking has had its effect upon economic progress by selecting the uses to which the loaned funds were put. It would be difficult to overstate the importance of that allocative function of bankers, but there is no use to labor the point here. More important in the present context is the value of this service, and of the skills required to produce it, to all persons concerned, borrowers and depositors alike, and ultimately to the whole economy. Thus some of the profits of banks and the salaries paid to bank personnel are compensation for the vital service of managing money. Sometimes when people speak of managing money, they are thinking only of the role of the monetary authorities. We must never forget that commercial banking also has its role, and it is the larger role.

In our third general classification of service produced by banking we will include a variety: trust services, fiscal services for the Government, handling foreign exchange transactions, and all the rest, which you know perfectly well. About each of them a great deal could be said, but need not be said to this audience.

Having all these services in mind, is it not reasonable to say that growth in demand for them is a manifest characteristic of a progressive and progressing economy? As the economy grows and becomes more complicated, is it not inevitable that more and more market transactions will have to be consummated? As wealth increases and the volume of financial assets burgeons, is it not sure that need for the services of banking and other financial institutions will grow? I venture to assert that in the

future, as in the past, the volume of service produced and sold by the banking industry will depend in important part upon how quickly and how efficiently banks recognize and adapt to the public's growing and changing demands. I think it safe to say that the public's demands will be satisfied. To the extent that banking fails to satisfy them, somebody else will.

Not let us turn to the past - the postwar past - and observe how banking has performed. Since the United States has a free market economy, we have convenient measures in dollar terms for comparing the values that the public places upon various goods and services. One good measure for comparing industries over time is the dollar value of the part of gross national product produced in each industry. In the case of banking, the measure consists of total wages and salaries paid by banks plus the total profits accruing to the owners of banks, i. e., dividends plus retained earnings. This is the measure of what the nation pays for the services produced and sold by banks. Note parenthetically that expenses of banks for supplies and equipment are not included, because under the scheme of the national income accounts they appear elsewhere in the value of goods and services produced by other industries.

In the postwar period, 1946-60, the part of our gross national product that was produced in banks grew faster than the national total, thus contradicting any notion that banking is not a growth industry. You might be surprised to know that employment and wages and salaries in banking grew more than the corresponding national totals. Furthermore, bank net

profits after taxes increased more than did total profits after taxes of all corporations. The growth of banking's product has been at a steady rate. In the 1953-54 and 1957-58 recessions, growth persisted, although the rate slackened a little. The value of farm production, by contrast, declined over the fifteen-year period, and in addition showed some instability. Automobile manufacturing increased sharply from the war's end to 1950, and has since shown little growth and wide cyclical swings. The value of services produced by insurance carriers rose faster than that of banking until 1949, and since then has roughly paralleled banking, but at a slightly slower growth rate. I shall not multiply examples; many others could be cited.

Average annual income per bank employee, however, has not grown as fast as the average in other industries. In banking the total number of people employed has grown faster than total wages and salaries have grown. The experience of certain other industries has been exactly the reverse. More about this later.

The aggregative measure of banking performance in the postwar period as revealed in the national income accounts presents on the whole a gratifying record. The old stereotype of banking to which I referred in the beginning is found to be inaccurate and misleading. The banking industry has not been static; on the contrary, it has exhibited dynamic characteristics comparing favorably with those in other industries. For purposes of analysis, it would be interesting if we could interpret this performance in terms of costs and earnings, especially the costs of and earnings on particular services or categories of services. But this is not an easy matter. Difficulties

are encountered when we attempt to identify in the conventional income statements of banks the payments for the major services discussed earlier, and the net returns earned thereon. I shall have to be content with indicating a few points that the statements suggest.

Both current operating earnings and current operating expenses have shown growth in the postwar period, and both have grown at almost exactly the same percentage rate. In each recession there was a slight falling off in the rate of increase of operating earnings, reflecting, no doubt, declines in interest rates and contraction of loan volume. Net profits, however, actually increased in each recession. There is no need to point out to bankers that this reflected capital gains realized upon sales of securities, a sort of reciprocal of declining interest rates. This behavior of bank net profits is remarkably different from the experience of other corporations. Two other developments in the postwar period deserve mention. There has been a decline in the relative importance of interest on Government securities as a segment of bank earnings; and interest on loans has risen in relative importance. Attention is attracted also by increases in miscellaneous sources of income, for instance, service charges. A notable aspect of operating costs is the rise which occurred in interest paid. No comment on causation is necessary as to that.

On the whole, it may be said in summary that the income of banks has kept pace, or more, with rising costs. In this we find corroboration of other evidence that banking has displayed the dynamic characteristics of a

growth industry. In addition, its net profits have presented a resistance to cyclical downswings of economic activity that may well be called unique. Why, then, does one hear it said that banking is a static industry whose prospects are likewise static? Why does one hear that it is hard to attract bank capital? Why does one hear that it is hard to attract bright young people to banking as a career? Is there something in the outlook for the future that belies the past? My crystal ball is no better than anybody else's, and probably not so good as most, but as I continue to view banking as an industry, as distinguished from looking at particular banks, I think some interesting things can be said with fair confidence.

Let me iterate a statement already made. Growth of demand for banking services is a characteristic of a progressive and progressing economy. We may expect this to continue. As there are more and more market transactions to be consummated, the clearing and bookkeeping activities of banks will continue to expand whether bankers want them to or not. However, we should not expect all banking growth to occur in the services presently and traditionally rendered. I do not hesitate to predict that the public will want and demand, as the years go by, new kinds of financial and banking services we have not yet imagined. It is to be hoped that banking itself will take the lead in most, or at least some, of these innovations. Take a current example. In some places a start has been made in providing credit for financing students in institutions of higher learning. A casual examination of population figures and projections, of education costs, and of national goals for education of our young - these

things and others suggest that this small start may only scratch the surface of a large area of financial service which somebody is going to take over. Heaven knows how many such new areas there are or will be.

Those who paint a dark picture of banking as a static industry point to one example or another in which it is alleged that banking missed the boat. Concede, for the sake of the argument at least, that there were such instances. Who is there that has not muffed an opportunity somewhere, sometime? Nevertheless, the record of banking, as we have seen, reveals growth and dynamism in spite of shortcomings. It is the nature of the industry and of the services it produces to grow and expand as the economy progresses. Only one thing can prevent banking from continuing on a similar course in the future, a failure to keep abreast of changing times. Banking must keep abreast; it must sharpen its awareness of change in the public's demands; it must not miss the boat in the current technological revolution in such things as data processing and paper handling. Let me revert for a moment to a fact noted in passing a few minutes ago.

We observed that in banking the average annual income per employee has not grown as fast as the average in other industries. Assuming that bank employees are fairly paid in relation to their productivity - I assume no banker will want to controvert this assumption - one must conclude that productivity has not kept pace in banking, as compared with other industries. Therefore, in the technological revolution that is taking place, affecting banking as well as nearly everything else, bankers will discover, if they have not already done so, that adding more employees to handle the expanding volume of work is no longer enough. Wage rates are likely to continue rising, as a consequence

in part of productivity increases in other industries. Since banks must compete for employees in the same labor markets frequented by other industries, it is obvious that banks will be at penalizing disadvantage unless they take effective steps to increase productivity in their own industry. Considering the current revolution, which I keep mentioning, in paper handling and data processing, it may well be that banking now has before it the challenging possibility that it can effect growth in the future at a faster rate than in the postwar period, not only in terms of total value of services produced but also in average annual income per employee. To those who worry about the difficulty of attracting bank capital and attracting bright young people to careers in banking, I suggest this as one of the most hopeful of all approaches.

A good start has been made by American banking in the direction of increasing productivity in the largest volume operations of all banks: check collection and bookkeeping. Many of you will remember only too well how during World War II, when manpower was scarce and banking had no priority in call on available resources, the burden of paying checks or returning them unpaid on day of receipt became unduly heavy. Delayed posting and delayed return of unpaid items were expedients adopted in extremis, though all agreed that to introduce delay in collection procedures would be a backward step. Came the end of the war and eventual replenishment of manpower resources available to banks, but the burdens of paper handling and bookkeeping grew and grew. Banking was in a bind. Expansion of demand for its product was cause for satisfaction; but concomitant growth in the burden of dispatching the work was cause for worry. Someone remembered, I make it up in my

imagination, that necessity is the mother of invention; and he said, "Let us have machines, mechanical, electronic, or whatever it takes, to save us from this morass of paper handling and bookkeeping." This may sound fanciful, but I think it is the essence of the story behind MICR, the magnetic-ink-character-recognition system of high speed check handling, for which equipment is now in the development and testing stage. The development of electronic computers and high speed printers for use in many businesses for many purposes now offers assistance to banks in their problems of bookkeeping and recordation, as well as teaming up with MICR in the processing of checks.

Banking can not afford to let this MICR development project lag or fail. I have no fear that it will fail so far as the engineers and technicians are concerned. Those fellows have a way of doing the impossible. The critical factor is in the area of bank and bank-customer cooperation. There is no use to perfect MICR or any other automated system of handling checks unless banks see to it that checks are in a form the equipment can handle. It is no good to keep the machines busy kicking out rejects. Thus there is work for banks to do, not only with respect to the checks that they procure and furnish to customers, but also with respect to checks that customers procure for themselves. It can be done; this was proven in the uniform routing symbol campaign. It must be done again, and it needs to be done faster than before. This is banking's project; it is not just a Federal Reserve effort, although the Federal Reserve System is doing all it can by

way of cooperating with and assisting the American Bankers Association. This is, on one big front, American banking's attack upon the problem of productivity, which I have tried to show is of such great importance to the banking industry, and to officers, employees, and stockholders of banks.

You will pardon me, I hope, if I seize upon another subject of current interest to illustrate the kind of alertness than can serve banking well in the time ahead. It is scarcely necessary to remind you that the American people have rediscovered a thing called balance of international payments. This is a complex subject comprised of a bundle of complex topics. Suffice it for my purpose to say that the realization has come home to us with whacking impact that our balance of trade, one of the complex components of the bundle, is obviously not predestined to be always favorable. We have to work to make it favorable and work some more to try to keep it so, at least a good part of the time. In plain Missouri talk, that means we have to export more goods and services than we import. In turn that means our products have to be competitive both abroad and at home. But given satisfaction of these requirements, the export transactions of our producers have to be financed. Financing is the business of banking. At this juncture let me depart momentarily from the resolve to look at banking only as an industry, not at particular banks. There are, of course, many banks in this country that are already admirably staffed and equipped to handle foreign exchange transactions. When I consider, however, the dispersion of industry which is taking place here and the vast amount of effort that goes into the attraction of industrial units to smaller communities, it strikes me that there is

opportunity - indeed, persuasive incentive - for many more banks to devote some part of their resources and efforts to the encouragement and financing of export trade. In cooperation with city correspondents who already have the know-how, and with the Export-Import Bank of Washington, which exists for this purpose, I suggest that a new field of profitable endeavor is awaiting your entry. In a progressive and progressing economy, this may be a hallmark of your individual progressiveness and progress.

We have spent about as much time as I propose to take now in looking at banking as an industry producing and selling services in a progressing economy, though some of the points I have tried to make would bear elaboration. Let me summarize briefly. We have seen that the banking story of the last fifteen years offers no basis for long-faced pessimism about the outlook for banking, unless we assume some radical change in circumstances beyond our power to master. Absent valid reason for such an assumption, I prefer to adhere to the doctrine that growth in demand for banking services is, and will continue to be, characteristic of a progressing economy. We have indicated that if bankers will exert themselves to continue to grow in alertness and resourcefulness, they may accelerate banking's rate of growth beyond the average of other industries. We have argued that an important objective of banking must be to improve productivity within the banking industry; and though I have said it before, I say it again: the opportunity to improve productivity in banking could hardly be wished better. There is enough on the drawing boards and in the factories already to offer high promise of unprecedented gains. Given a

fair distribution of the fruits of increased productivity, repair of the lag in incomes of banking employees, as compared with those in other industries, would seem to be within reasonable expectation. What deterrent to selection of banking as a career can be deduced from all this? I find none for those who possess the qualifications I postulated in the beginning: integrity, intelligence, resourcefulness, ambition, and the will to work.