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see inside for title.

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[on social responsibilities: amidst Energy shortage + capital shortage, what are the priorities for the banking communities?]

I am glad to be back in San Diego; as you might expect, it has come to be a familiar place for the FDIC Board of Directors, at least since October of 1973.

To a degree I am somewhat reluctant to approach you at this early hour with some reflections on the implications of a rather dismal speculation of mine. However, given the rosy picture painted by economists at this point a year ago and given our shared national experience in 1973 where just about everything that could go wrong in the economic sphere did go wrong, it seems to me that there is profit in the anticipation of difficulties. In any event, I do feel that there is much to be learned from the lessons of 1973.

Some months ago a veteran Washington official was quoted as saying:

> It always puzzles me that historians can be so uncertain about their analysis of the past and economists so certain about their forecasts of the future.

That remark reflects, I am certain, the frustration of many with the apparent failure of economists to anticipate the economic shockwaves of 1973. With this in mind, economists with a rare showing of professional modesty, are increasingly heard to express reservations regarding the adequacy of their crystal balls. One economist was quoted, perhaps apocryphally, as having stated: "If I didn't have to earn a living I would not make a forecast the coming year."

In a recent discussion with some of my colleagues at FDIC, Arthur Okun of the Brookings Institution and formerly Chairman of the Council of Economic Advisors under President Johnson, acknowledged that the events of 1973 had indeed caught economists unprepared. In late 1972 it appeared even to him, as one who had opposed President Nixon's economic policies, that they represented a well-managed and balanced path to prosperity. According to Dr. Okun, subsequent events severely challenged the assumptions and tools of economic analysts and forecasters.

Lest I be too harsh on economists, let me acknowledge, as a lawyer, that 1973 was not exactly what one might call a banner year for that profession -- what with the renowned Dean's List of lawyers; banking too, was hardly sacrosanct as events here in San Diego showed.

In recent weeks, the energy shortage has frequently prompted discussion of the enormous capital requirements projected in the energy industries over the next few years. With this in mind, as well as the feeling that the mysteries of economics have been left too much to economists, I have been trying to learn what a barrel of oil is and to learn what the shortage of that barrel of oil and of scarcity generally might mean to our financial institutions and capital markets.

My education in these matters has just begun, as I gather is the case for many economists as well. It is apparent to me, however, that some of the basic assumptions, not only of economists, but of us as regulators and bankers must change if we are to serve the public interest and that of our financial institutions.

What I would like to share with you today are certain reflections flowing from my initial investigations into the economics of a world in which we no longer rest assured of the luxury of plenty and in which, for the present, the only economic certainty sometimes seems to be the absence of certainty. I anticipate that I can provide little in terms of facts or theory of which you are not aware. I hope, however, to focus attention on certain implications of the facts that we do know which may be obscured by the climate of immediate crisis created by Watergate and the energy situation.

With real or imagined shortages in everything from toilet paper to the basic materials which are the building blocks of an industrial society, I have become increasingly concerned that we are facing yet another shortage -- a shortage of sufficient investment capital to finance development of the resources required to meet national, state and local goals. I am concerned that this shortage is of substantially more significant proportions than that reflected in recurring periods of tight credit to which we have become accustomed.

In light of my own specualations, I was especially interested to read the recent speech by Chauncey E. Schmidt, vice chairman of First National Bank of Chicago, given before the World Banking Conference in London entitled, "A World Dilemma: Deficiency in Capital Investment". There Mr. Schmidt made the flat prediction: "We are going to have a capital shortage in the future." While I do not yet have either the precise data or the analytical tools to demonstrate conclusively the likelihood of such a shortage, I would like to focus briefly on some of the factors which suggest that my concern may be well-founded and Mr. Schmidt's prediction accurate.

The first of these is, of course, the nation's need for energy. You have no doubt seen the various estimates of capital that will be required by the energy industries. A report issued by the National Petroleum Council in December of 1972 estimated capital requirements for the aggregate of the U.S.'s energy industries for 1971 through 1985 to be between $450 and $550 billion (1970 dollars). With current conditions in mind, independent analysts now project significantly higher figures with estimates ranging as high as $1 trillion. One observer, Tilford Gaines, senior vice president and economist of Manufacturers Hanover Trust, estimated that the capital requirements for the fossil fuel industries alone may exceed $400 billion in fifteen years, 1971 through 1985, with capital outlays for the electric power industry on the order of approximately $350 billion (1971 dollars). Federal Reserve Board Governor Robert C. Holland, in an October speech before the Financial Conference of the National Coal Association, reached a similar conclusion, finding the figure $700 billion to be a reasonable estimate for long-range planning purposes.

Under the best conditions, such needs would portend signficant financing problems for the institutions involved. The coal industry has been plagued in recent years by poor earnings and it is likely that long-term guarantees or contracts with users will be required to attract the commitment of major capital resources. Furthermore, the electric utilities have the special problems of rate regulation with local rate makers having to adjust to dramatic and uncertain rises in the prices of primary energy and rates of return which will attract the requisite capital. Additionally, the task is made more difficult by the depressed conditions of the equity market and the tightness of money generally.

Nevertheless, I am confident that these capital requirements, staggering as they are, will be met. The atmosphere of crisis and focus of public attention would seem to insure this, whether through innovative financing arrangements, investment incentives, the creation of a Federal Energy Bank, or some other means or combination of means. What is of greater concern to me is that in responding to the energy crisis, we will allow other competing needs which are equally critical to the health of our society to be shut out of the market.

If the $700 billion estimate of capital requirements for energy used by Governor Holland is reasonable for the period 1971 to 1985, and if $2 - 2.2 trillion projected by McGraw-Hill and others is a fair prediction of total business investment during the same period, then energy investment as a percentage of total business investment will increase from its level of approximately 21% between 1961 to 1971 to approximately 30% during the period 1971-1985.

To further compound matters, the ability of the Arabs to shut off oil supplies has led to increased concern in other areas where the U.S. is significantly dependent on foreign suppliers. According to C. Fred Bergsten, a senior fellow at the Brookings Institution, four countries control more than 80% of the world supply of copper; two countries account for more than 70% of the supply of tin exports; four countries control half the supply of natural rubber; and four countries possess over half the reserves of bauxite. Recently John D. Morgan, Jr., acting director of the U. S. Bureau of Mines, said in an interview:

> We are not in a minerals crisis at the moment, but we must take cautionary action to avoid being in one a short distance down the road.

For cautionary action, Morgan has advocated more research, increased geological searches for minerals, better metallurgical work, improved methods of recycling used metals, larger inventories by industries, and studies to determine whether tax and other incentives should be produced to encourage greater utilization of domestic supplies. In short, to protect against a repeat of the oil crisis, Director Morgan called for increased capital expenditures in the basic minerals industries. Morgan's observations are supported by forecaster Gaines' prediction that capital spending in enlarging mining and refining capacity of minerals other than oil and gas would double the current annual rate and would amount to at least $150 billion (in 1971 dollars).

Combining these figures with his forecasts in the energy related areas and with his projection that capital requirements in telephonic communications would amount to $200 billion in the period 1971-1985, Gaines predicted that:

> The total estimated spending by the energy, communications, and metals industries alone in the fifteen years 1971 through 1985 in constant 1971 dollars, adds to approximately $1.1 trillion,

or 50% or more of total spending on plant and equipment by American industry projected for the period.

As a final cheery fact, we all know that there is evidence that, while energy seems to represent the most dramatic shortfall, our problems in that area coincide with a more general shortage in basic commodities. Former chairman of President Nixon's Council of Economic Advisors Paul W. McCracken recently observed:

> We are dealing with an explosive commodities inflation. In the current expansion, we have obviously run out of plant capacity before we have run out of employable labor.

And, in the same vein, Tilford Gaines states:

> After allowing for price inflation and purely environmental capital investments, it now appears that for the past five years we have not been adding to capacity at all.

These statements were confirmed by the Federal Reserve Board's index of twelve major industrial industries which showed that such industries as paper, oil, refining, steel and cement ran at a record rate of 96.3% during the third quarter, virtually at their operating ceilings.

While usage of real industrial capacity may be expected to drop temporarily as a result of the energy shortage, businessmen and economists are in general agreement, however, that a significant increase in this real industrial capacity in the basic materials cannot be long postponed if we are to avoid increasing bottlenecks, rising unemployment, and economic stagnation -- this coinciding with our needs in the energy field.

The forecasts I have cited, rough and debatable as they are, dramatize the fact that a great deal more investment capital will be needed to perform the basic tasks necessary for the well being of our economy and our society generally. Of equal, if not greater, importance, is the continuation of the journey we have only just begun to protect our environment, rebuild our cities, provide adequate housing for the disadvantaged, expand health services and develop effective and self-sufficient systems of mass transportation both within and between our cities. It is in the light of these and other critical demands for capital investment that I perceive the possibility of a "capital shortage".

I am well aware that in the technical parlance of many economists, a capital shortage is conceptually impossible. By this they mean simply that when demand exceeds supply, the price mechanism will serve to ration the resource in question -- capital in this case. It seems to me, however, that there may be said to be the equivalent of a shortage of capital when the price mechanism works to drive from the market the demand for capital necessary to achieve such ends as those enumerated before. Although the uncertainties of the present argue against any flat prediction, there is the strong possibility that there is such a shortage.

In the context of this possibility and given the realities of our present energy and commodity shortages, certain observations regarding the role and responsibilities of bankers and other financial managers seem appropriate.

At the outset, it should be said that the business decisions of bankers and others who supply capital can no longer be based on the sole criterion of profitability of that loan or investment. I submit that lending policies must reflect an institution's responsibility to its community. Institutional objectives, many of which will be based on sophisticated and tough-minded economic analysis, may outweigh conventional credit judgment. For example, a loan to an expanding educational institution should take priority over a local country club's request for funds to build a second golf course. At a time when many basics are in short supply and when competition for available capital is intense, a bank or other institution which does not recognize its involvement in this new environment and its duty to help preserve and protect the significant needs of the American people may find that it has forfeited public and political support. Unless a bank is socially useful it has little right to be economically successful.

While this perspective reflects my view that banks are vested with a public trust and hence have responsibilities beyond their own economic interests, it is also my judgment, based on years of experience as a bank lawyer, banker, and now regulator of banks, that such a perspective is absolutely consistent with the interests of financial institutions. In his new book, Future Without Shock, Louis B. Lundborg, former chairman of the Bank of America, states:

> The investment community will recognize, as never before, that business involvement in social needs is a sine qua non for long-term investment performance. Already some security analysts and some institutional fund managers are trying to factor a company's social performance into their investment analysis and decision.

Not only is such conduct mandated by our responsibility to the society which forms the context for profit, but it reflects a recognition of the fact that the health and maximization of value of a financial institution is directly related to the health and vitality of the community which it serves. To take the most simple case, surely it is obvious that traditional analysis of risk and return do not reflect the entire value accruing to a bank as a result of participation in the financing of a mass transit system in its community. While it is no doubt difficult to quantify such value, failure to give it adequate weight in evaluating loan or investment decisions is simply not good banking.

In short, it is my view that socially responsible conduct and sound and profitable banking are not mutually exclusive.

Suppose, however, that those who support the well known theory that the "business of business is business" were to disregard such responsibility, I believe that we will then see two direct consequences -- neither desirable.

In recent weeks we have seen the establishment of a Federal Energy Office, the publication of extensive regulations coupled with the suggestion by Senator Jackson that oil companies be federally chartered and the proposal by a Republican President of an excess profits tax.

These should serve as strong reminders to those of us who believe in the private enterprise system that failure of the private sector to anticipate and avoid shortfalls in areas critical to the health of the society will necessarily lead to governmental intervention. Housing was one such area; energy and related industries is another.

Although such intervention is often the necessary response to crisis or profound need, the disadvantages have been well catalogued and need not be restated here. In a "shortage economy" the likelihood of further extension of federal power is greatly increased. Only responsible allocation of resources and careful attention to community interests within the private sector will prevent such further expansion of the public sector.

The second consequence of the failure to appreciate community responsibilities is equally serious. As a bank regulator whose primary charge is the maintenance of public confidence in our banking system, I am aware, as you are, that events of recent months have created a severe crisis of confidence in our institutions -- public and private.

In this regard we should acknowledge that, with capital in short supply relative to demand, the temptation to cut corners will be great. While I feel very strongly that innovation in financing arrangements will be required to utilize to the fullest the available capital resources, this temptation to cut corners must be avoided.

With bank earnings at high levels -- reflecting in my opinion the emergence of innovative and aggressive management techniques as well as high interest rates -- and with the increased capital requirements in the energy field creating further opportunity to increase profits, it is important to keep in mind that oil company executives are not the only ones subject to call before a Senate Committee. Nor should those associated with the banking industry discount the potential for public reaction to the calamities which befell the former U. S. National Bank of San Diego and the reasons therefor. In a more normal year, the impact of the collapse of U. S. National would almost certainly have been more serious.

Neither the nation nor the banking industry can afford the decline in institutional confidence that we have seen in other areas of our national life. Confidence cannot be maintained in the face of shaky practices, bank failures, profiteering or, in general, the failure to place highest priority on the public interest.

Finally, it seems to me that the implications of a shortage economy must be examined in discussions of the Hunt Commission Report, the Financial Institutions Act of 1973, the various proposals which have been made for reordering the roles of financial institutions and regulatory agencies, and in the development of new proposals for the more efficient functioning of capital markets. Overlaying this discussion must be an awareness of the vast power -- whether consciously exercised or not -- that is vested in those whose decisions significantly affect the shape of capital flow in a nation which for perhaps the first time in its history may have to accept the fact that not every one of its capital needs will be met.

In conclusion, I should reiterate what must be plain by now. I take very seriously the notion that unless a bank is socially useful, it has little right to be economically successful. In the present climate of economic and political stress, bankers cannot risk any other posture.

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