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An Address By

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Washington, D.C.

before the

Annual Convention of the

ARKANSAS BANKERS ASSOCIATION

in

Hot Springs, Arkansas

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I appreciate the opportunity to speak to you this morning. These are interesting and challenging times--times that call for a high degree of imagination, foresight and responsibility on the part of bankers as well as the rest of the economy. Banks have had to respond within a relatively short span of time to rapid changes in their operating environment--both in the economy at large and in the financial sector in particular. Even more worthy of note, however, is the growing realization among banks that the present situation of high levels of economic activity and constant change will probably remain with us in some form or other in the years to come.

Now we have advanced to the stage where we can influence perhaps but not completely control fluctuations in business activity. Yet we are continually adding to our store of knowledge in this area, despite the fact that the economy itself is in a constant state of flux. Our understanding of the complex economic forces at work today is continually being strengthened, and new tools of economic analysis developed and refined. As a consequence, access to more and better information and to a greater variety of analytical and operational tools have placed us in a better position to cope with current problems and to deal with challenges in the future.

At the present time, we are facing a situation that is in many respects unique. After several years of substantial underemployment of our plant and manpower resources, the economy has finally succeeded in essentially overcoming these problems. Gross National Product reached a record annual rate of $714 billion in the first quarter of this year. Industries are operating on the average close to their preferred rate of 92 percent of capacity. The jobless rate has fallen below the interim target of 4 percent--and was at 3.7 percent last month. Industrial production, personal income, capital spending by business, new orders placed with manufacturers, and employment are only some of the major economic indicators that are showing continued vigor. The current expansion is now in its sixth year. Some of the current strength of the economy is of course attributable to the recent step-up in U. S. commitments in Vietnam.

Superimposed on an already booming economy, the requirements of the Vietnam conflict have been an important factor in the upward pressure on prices in recent months. U. S. involvement in Vietnam has brought into question the sustainability of the current expansion and of our past record of relative price stability. Demand pressures have been reflected in rising prices of many of the things we buy and in the cost of money. But the prognosis is still uncertain; the various major economic indicators still present a mixed picture.

Some of the strong expansionary forces could moderate as the effects of monetary restraint increasingly take hold and as the recently enacted tax measures and increased Social Security deductions hold down income growth. The supply situation may be eased by substantial plant capacity coming into production as a result of the large capital spending programs of earlier years. More people are constantly entering the labor force, while certain categories of the unemployed can still be drawn into productive employment. Vietnam is the principal imponderable injecting a substantial degree of uncertainty into the economic outlook. Up to now, the economy's expansion has been steady and generally well-balanced. Ill-timed actions that could supply a sharp check to the economy's growth must be avoided. The cooperation of all sectors of the economy that contributed to the good economic record of the past five years must not be terminated.

The present situation requires that we employ to the fullest our capabilities and our resourcefulness. With an economy close to full employment levels, our margin of maneuverability has narrowed. Banks, for example, are discovering that their ability to satisfy private credit demands is being hampered by declining liquidity. And savings inflows are running below year-ago levels despite higher interest rates on savings. At the same time, banks are filling a larger proportion of the nation's credit requirements because of strong demands for credit by the business sector.

The banking industry has been able to meet these demands through the development of diversified lending facilities and services and through the introduction of new savings instruments, such as the large-denomination negotiable certificates of deposit and, more recently, by savings certificates and similar instruments designed to attract the small saver. Liberalization of the maximum rates payable on time deposits in recent years has helped to make these commercial bank savings instruments more competitive with other money market assets and with other investment outlets for savings funds.

The current limited supply of savings in relation to demand presents a clear challenge to management. The margin of error that can be tolerated in bank management decisions is necessarily smaller. Bank managers must call upon all of their ability, understanding, and imagination. Current policies might usefully be reevaluated and possible modifications considered to fit constantly changing circumstances. For example, credit and investment policies heavily dependent on a continuing inflow of corporate idle balances--in a period when these inflows are shrinking--might be reexamined. Liquidity requirements associated with the holding of these essentially short-term corporate balances should be reassessed by each bank. As a longer range policy, consideration might be given to a lessening of dependence of these corporate funds as a source of deposit growth. These are only some of the fundamental issues facing banks today.

Management decisions in any event--but to an even greater extent today--must be taken with prudence and with the view of serving the public interest. The decision to compete for loanable funds thus should be determined by the individual bank's ability to use those funds productively and profitably--and not solely by what its competitors are doing. Even those banks experiencing strong demands for credit from creditworthy borrowers must exercise selectivity in the present economic environment by extending credits for productive, nonspeculative uses. Some of the newer savings instruments, in addition, should still be used with caution until their respective advantages and disadvantages are more fully understood.

Because of the growing importance of the recent innovations in the savings market, the FDIC and the Federal Reserve are simultaneously conducting surveys to develop more information on the nature of the market for time and savings deposits--including the types of instruments offered, rates, maturities, and other characteristics. The FDIC survey covers insured banks not members of the Federal Reserve System, while the Federal Reserve System, while the Federal Reserve survey is directed toward its member banks. The participating banks are being asked to complete and return the questionnaires by May 18. We hope to publish the results of the survey as soon after that date as possible.

A major question that has arisen in connection with many of the newer savings instruments is their cost to the bank in terms of both actual interest cost and their net contribution to bank earnings. This question represents but one facet of the growing cost consciousness of banks. Heretofore, the attention of banks has been focussed largely on growth through the attraction of deposits. Now, banks are rightly becoming equally--if not more--concerned about the profitability of their operations. This concern has in part stemmed from rising interest rates and other bank costs in the context of the current high levels of economic activity.

I have therefore been most interested in the bank-cost study initiated by your Education Committee in 1965 in which some 65 banks of various sizes participated. Your study is a pioneer effort for your area and for state bank associations. It provides the participating banks with a better idea of costs by different functions and the revenue-producing value of various activities. It thus provides a stronger foundation for future planning, for introduction of programs of cost reduction and control, or for the development of new services. It facilitates optimal use of available funds.

Studies such as yours are particularly helpful to smaller banks that cannot set up elaborate and continuing programs of functional cost analysis. Similar programs are being conducted by large banks in some sections of the country for their small correspondent banks and by a number of the Federal Reserve Banks for those of its member banks interested in participating.

The FDIC this year also began a bank cost study--but with a somewhat different orientation. The study will attempt to isolate the determinants of changes in some major elements in bank costs over time. The study reflects past performance records of banks, but its principal emphasis in on the development of norms that might be used by banks to determine future bank action and policies. This is a pilot study exploring a highly complicated subject. Definitive results will be available for some time, but they will be made available to all banks.

I have touched on only a few of the most important issues in banking today. Before closing, I would like to mention one additional area in which your Association has recently made a major contribution---the development of bank managerial talent. The endowment by your Association of a chair of banking at the University of Arkansas and the establishment of scholarship programs at other Arkansas colleges for "potential bankers" will contribute greatly to our knowledge of an innovative, evolving, and adaptable industry and to the supply of the vital managerial talent that the growing banking industry needs. Good bank management is an essential ingredient of a successful bank. Your Association has forcefully demonstrated its capacity for foresightedness and imagination in many areas, and has shown concern for the interests of both its members and the public at large. It has been a privilege to talk to you.

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