CREDIT IN AN EXPANDING ECONOMY

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I am happy to be in Montana again. I have traveled through Montana on several occasions, all of which were pleasure trips, so I welcome the guise of a business trip in order that I might visit here again.

I had heard that this would be the last meeting of the Helena Forum, but I am happy to find this is not the case. Perhaps I shouldn't be sensitive on this point, but I was afraid a disturbing trend was developing. In April I addressed the Pacific Northwest Conference on Banking in Pullman, Washington, and was informed thereafter that the Conference would cease operations after many years of success. Now this in itself would not be too alarming, but I can also remember when I was dating the young lady I married. One of our favorite eating places was an old building several miles outside Baton Rouge, Louisiana, named Old Hickory Inn, so named because Andrew Jackson spent some time there. Old Hickory Inn was full of wonderful atmosphere -- checkered tablecloths, candlelight, fireplace, and an old creaky floor. In fact, this was the spot at which I placed the engagement ring on my wife's hand. Shortly after our engagement Old Hickory was demolished to make way for a new highway. Then, on our honeymoon we went to a beautiful spot named Inn by the Sea on the Gulf Coast. Within a year, the hotel was torn down and replaced by a U.S. Merchant Marine Academy. As you might guess, I am gradually coming to think of myself as a similar character to J. Digby O'Dell, the friendly undertaker. So if any of you has a project which needs termination, you might consider my services.

Perhaps you have heard that purebred beef cattle is one of my occupations. This being so, Montana -- and all of the West -- fascinates me. One of your own purebred Hereford breeders moved to Alabama in 1944 for health reasons. His name is Lon Chatterton. Although somewhat weatherbeaten, he is a distinguished cowman. In spite of the fact that my opportunities to visit with him have been limited, we have developed a good friendship, notwithstanding the fact that he is about 40 years or more my senior. He is still interested in good beef cattle, his life's work, and apparently will be until the end in the finest traditions of a cattle breeder, a Westerner, and an American. His love for Montana has never died. In fact, he clearly shows his affection by naming most of the female offspring of his herd "Miss Montabama 1st," "Miss Montabama 2d," and so on. People like Lon Chatterton are valuable assets of our country regardless of where they hang their hats.

And so it is a pleasure to be here in Montana and reminisce. Frankly, I would enjoy talking at greater length about Herefords and people. But something tells me you are interested in banking, and you would be surprised -- and maybe disappointed -- if I didn't talk a few minutes about a subject related to banking.

I do value this opportunity to meet you bankers, to hear your views, and to learn from your experiences. You are continuously in contact with the great diversity of industrial and agricultural enterprise which contributes to the economic progress of our country. And it is perhaps here in the West that we see most clearly the richness and variety of our country. Western bankers have an important role in furthering the progress and expansion of our economy in all lines of endeavor.

The growth of our economy cannot proceed without the continued development of adequate and appropriate credit facilities. The banking system has a vital role to play in this respect. It has expanded in the past -- and will no doubt continue to expand in the future -- so as to provide its share of the credit needed for economic growth.

Monetary policy is a day-to-day process in which our Board continuously reviews and analyzes current tendencies in the banking system, in credit markets, and in economic activity. But the meaning we attach to short-run banking and credit developments and our understanding of them depend to a great extent on our awareness of longer-term trends and of the basic relationships which underlie and influence current conditions.

Tonight, I would like to focus attention on some longer-term considerations. I particularly want to discuss the functioning of credit markets generally. It would be presumptuous of me to explain the role of banks to bankers, and maybe it is only a little less presumptuous to discuss the broad role of credit markets with active participants. I would like to think, however, that an over-all view of credit markets provides an interesting perspective for the role of banks.

No one institution can be understood in isolation. The evolution and structure of the banking system cannot be fully understood unless consideration is given to the evolution of other market institutions. Similarly, other market institutions cannot be fully understood without studying their relation to each other and to the banking system. The Board of Governors has been concerned with and studying these relationships for many years.

Credit market institutions are primarily related to each other through the forces of competition. They compete with each other in providing funds to borrowers and in attracting saving. To a large extent, savers can choose among alternative investment opportunities, such as savings deposits or Government securities, and lenders can make use of alternative means of financing. Market institutions are by and large intermediaries between savers and lenders. Their continued growth depends on their ability and willingness to satisfy the evolving needs of ultimate buyers and sellers of credit in markets.

Because of the character of their liabilities, market institutions tend to concentrate their lending activities in particular market segments. Commercial banks, for example, which have the shortest-term liabilities, tend to concentrate on shorter-term lending, although intermediate and longer-term loans have become important components of bank loans. Pension funds, on the other hand, have long-term and relatively more predictable liabilities, and their portfolio is made up more of comparatively long-term assets.

Between these two extremes there are many gradations, with some institutions specializing more than others, some investing in a wide variety of long-term credit market instruments, and some willing and able to take greater risks than others. Differences in the function and nature of market institutions are not so great, however, as to limit them to particular groups of borrowers or to set shares of a particular market.

When mortgage demand rises, for example, banks, insurance companies, and savings and loan companies all compete for the expanded demand. Expanded corporate financing demands can also be satisfied by different institutions in a variety of ways. Thus, within limits, market institutions can divert their lendable funds to different uses and, in doing so, each will compete with the others to some degree.

Market institutions compete not only in lending funds but also in obtaining funds. They compete in this way because, again within limits, savers consider alternative forms of financial investment almost equally suitable to their needs. As an example, savings deposits and U.S. Savings Bonds are evidently closely competitive, because they both serve similar saving needs; such deposits and Treasury bills are also closely competitive, particularly for the liquid funds of business.

Savings institutions might obtain more funds by raising the interest rate paid to depositors; this, of course, makes Savings Bonds or Treasury bills a relatively less attractive investment. Funds available for such things as mortgages or bank loans are increased, but at the same time, completing the circle of effect, the cost of borrowing to the Government is raised.

The way in which I have brought interest rates into the discussion may make it appear as if market institutions can increase the price they pay for funds at will. Needless to say, they cannot. Apart from institutional and legal restrictions, an institution cannot permanently pay more for funds than it can obtain on lending them, after allowing for operating costs and reasonable profits.

The level and pattern of interest rates are by and large a reflection of market forces. Broadly speaking, movements of interest rates express the forces of competition as savers, market institutions, and ultimate borrowers all come together in the market, some seeking to find the most profitable use of their funds and others seeking the least expensive source of credit. In this process, the credit market helps to allocate the country's productive resources to uses that correspond with the inclinations and needs of the people.

We often say, as I have just said, that a smoothly functioning financial market helps allocate the country's productive resources and, further, that it is essential to continued growth with stability. But you might ask how, in fact, are financial and productive resources phased together? This is an easier question to pose than to answer.

As part of the answer, we can look to experience. As our economy has grown in complexity, and more goods fulfilling diverse needs have come to be produced, so have our financial markets broadened and deepened. In a free economy this comes about in response to the expressed need of the people, who find that institutions, as they exist, are inadequate to the financing requirements of their growing and changing demands for goods and services.

The rapid expansion of short- and intermediate-term consumer credit and of consumer mortgage debt during the past fifteen years is a remarkable example of the adaptation of financial markets to nonfinancial needs. The amount of such consumer debt outstanding has expanded almost 8 times from its end-of-1945 level. By way of contrast, nonfarm business debt has risen about 3-1/2 times its level at that earlier date and farm business debt less than 3 times.

This rapid expansion of consumer debt was facilitated by the readiness of banks to expand their consumer loans or to provide finance to other market institutions who were, in turn, directly financing consumer purchases. It was also fostered by the rapid growth of savings and loan associations and by development of various other consumer financing facilities. The economy's ability to produce more consumer goods and, what is equally if not more important, the ability of broad groups in the population to purchase them were enhanced by the expansion of credit markets.

As another part of the answer to the question of how financial and productive resources are phased together, I might also present a hypothetical situation -- and what will appear to be an unreal situation. But sometimes we can sharpen our understanding by removing ourselves, briefly, from the world of experience. In this way, we can often more clearly see connections that tend to be obscured by concern with the problems of daily operations.

There are dangers involved in this. We have all heard of the man who cannot see the forest for the trees. By the same token, the man who cuts down trees in order to obtain a better view of the forest often finds in the end that he has no forest left to see. I hope to emerge, unharmed by falling trees, somewhere in between these two extremes.

At any rate, let us visualize for a moment an economy with no banking institutions, no other financial business, and no credit markets. Savers in that economy would not easily be able to transmit their surplus funds to prospective borrowers. They could transmit funds only by hand, and this could not be done efficiently or in any large volume. Most savers would have to use the funds themselves.

The country's use of its real resources would be limited. The capacities and inclinations of savers are undoubtedly different than borrowers. They may be less inclined to take the risks necessary to economic growth. Furthermore, they would be limited because the funds could only be used for outlays which could be completely financed out of their own earnings. All this would severely limit the country's growth possibilities. Such a lack of credit facilities would limit the extent to which people could make their choices effective in the market place.

Indeed, though in not so extreme a form, a situation similar to this prevails in many of the less developed countries of the world. Savers are not able to transmit funds to potential borrowers in their own country. Instead, funds are kept in a mattress or invested in foreign exchange. The saving, in other words, is not effectively mobilized to meet the country's needs. That is the function of financial markets.

By introducing into our hypothetical example an institution which can attract funds from savers and make them available to borrowers, the country's use of resources becomes more effective. Borrowers can undertake projects which yield their return over a longer period, and there will be greater investment in such things as factories which accelerate a country's growth.

I am in danger, I see, of leaving the impression that the proliferation or multiplication of financial institutions leads to greater growth. This is obviously not so. If I leave that impression, I have chopped down too many trees.

A large variety of financial institutions has no virtue in and of itself and an increasing variety bears no necessary relation to growth. Financial institutions expand successfully only if they are fulfilling economic needs. These needs are many. Among them are growth, but they also include provision for future personal security and a better distribution of the country's existing productive capacity.

So far I have been discussing why the development of financial markets is important to the country and why they are needed to transmit funds from savers to borrowers. Now I would like to turn to the question: Who are the borrowers in this country?

As I previously noted, consumers have increased their borrowing the most. They have also become the largest borrowers in the private sphere. At the end of last year, total consumer debt outstanding was $190 billion. This was larger than the debt of corporate business, which amounted to $140 billion, but corporations also finance themselves through equity issues as well as by borrowings.

By way of comparison, the outstanding debt of the Federal Government held by the public amounted to about $240 billion at the end of last year. The publicly held Federal debt has fluctuated from year to year since the end of the Second World War and is now slightly below the 1945 level.

While some consumers have borrowed to finance their increased expenditures on homes and durable goods, other consumers have been saving. Or often, the same person is both borrower and saver. At the same time as he goes into debt to buy a home, a consumer may also be accumulating financial assets.

The total value of financial assets held by consumers at the end of last year was about $920 billion. If we exclude the value of holdings of corporate stocks, financial assets amounted to about $520 billion. The magnitude of these figures makes it clear that we cannot successfully encourage the transfer of funds from saver to borrower without assuring the saver that his funds will not be eroded by inflationary conditions or will not be imperiled by severe economic decline and a disturbed and uncertain financial market.

The encouragement of broad, flexible, and responsive credit markets helps create conditions for sustainable economic growth. The country cannot grow in response to the aspirations and wishes of the people unless we have financial institutions and markets which mobilize saving and channel it into long-run investment purposes -- and an environment of monetary stability is essential to the further development and expansion of credit markets. Providing monetary stability is a challenge to the Federal Reserve System. The further development of credit markets is a challenge to our financial system, including that important segment, the commercial banks, and though these challenges are simple to view, they will be difficult to meet. But meeting challenges is nothing new to Americans. In fact, our ability to shoulder responsibility when "the chips are down" is our greatest heritage. We must continue to help build an even greater America -- the hope of freedom in the world.