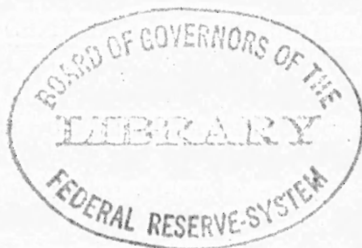

BANK CREDIT IN AN EXPANDING ECONOMY

Remarks of Harold King

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before the

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BANK CREDIT IN AN EXPANDING ECONOMY

I would like to talk to you today about monetary policy and commercial banking in the current business upswing. As you know, recovery from the 1960 recession began in March last year, and has now proceeded a little over a year. The occasion of your annual convention, therefore, provides an appropriate opportunity for examination and appraisal of our joint efforts over this period -- the determination and implementation of monetary policy.

Viewed from my position on the Board of Governors in Washington, this has been an important and eventful year for monetary policy. Judged on the basis of my conversations with bankers in various parts of the country, I believe you would also regard it as an important and eventful year for commercial banking.

Monetary Policy

Our monetary policy in the current business expansion is set apart from that in any other period of expansion over the past decade in that bank reserves have remained readily available throughout the recovery. In the recoveries following both the 1954 and 1958 recessions, Federal Reserve policy began a marked shift away from a policy of monetary ease within a few months after the low point of the recession.

This contrast in monetary policy is illustrated by the manner in which reserves have been supplied to the banking system. During the recent recovery and expansion period, the Federal Reserve has supplied increased reserve needs through open market operations while member bank borrowings have continued close to minimum levels. In the two earlier

periods, the Federal Reserve did not supply reserves needed to cover monetary expansion through open market operations, but rather they had to be obtained by banks through borrowing at the Reserve Banks. A high level of such borrowing, which is undertaken with reluctance, tends to be associated with restraint on credit expansion.

These policy differences have been dictated by fundamental differences in the economic environment within which monetary policy is formulated. For one thing, the current upswing follows a recession during which reserves were not supplied in as large quantities as in previous postwar recessions and interest rates did not decline as much. Thus, there was less need for offsetting action in this recovery period. Also, the present expansion in economic activity has not been accompanied by inflationary pressures and speculative tendencies as occurred after the 1954 and 1958 recessions. Substantial amounts of unutilized industrial capacity and a relatively high unemployment rate continue to militate against the development of inflationary pressures. Banker responsibility in the allocation of credit also has been a factor in these policy differences, for speculative use of bank credit, a problem in previous upswings, has been negligible this time.

In the current period, moreover, we have been confronted with a much more urgent balance of payments problem than earlier. We have endeavored, both in the recession and the recovery, to minimize downward pressures on short-term interest rates in the hope that we would not aggravate the outflow of short-term capital in search of higher returns abroad. The Treasury has also worked in this direction by adding to the supply of 90-day bills.

Reflecting these policy developments, the general level of interest rates on U. S. Government securities is little higher today than at the bottom of the recession in February 1961. In the early phase of the previous two upswings, the level of rates rose substantially.

One indicator of Federal Reserve policy commonly used both inside and outside the System is the free reserves position of member banks. This measure is obtained by subtracting member bank borrowings at the Reserve Banks from the total of their excess reserves. This net figure has tended to move over recent business cycles from roughly a plus $500 million in periods of recession, when credit demands are slack and Federal Reserve is following an easy monetary policy, to a negative $500 million, or a net borrowed reserves position of that amount in periods of monetary restraint, when credit demands are strong and Federal Reserve is pursuing a policy of monetary restraint. These $1 billion reserve-position swings occur mainly in the amount of member bank borrowing at the Reserve Banks. Excess reserves, which are concentrated mainly at country banks, fluctuate relatively little over the cycle, generally in the $400-$600 million range.

Over the past year, free reserves of member banks generally have averaged close to $500 million, or not far from the average in February 1961, the month generally regarded as the low point of the recent recession. Borrowings at the Reserve Banks usually have remained below $100 million or close to minimum levels.

Since excess reserves tend to be concentrated at country banks, free reserves over the past year also have been concentrated at these banks.

Large city banks seldom show any appreciable volume of free reserves. They tend to manage their reserve positions closely and invest promptly any temporary excess reserves that might accrue to them in short-term interest-bearing assets, such as Treasury bills. Rather than an indication of tightness, therefore, the absence of free reserves at these banks over the past year is largely a demonstration of their success in rapidly putting available reserves to work in expanding credit.

As a complement to maintenance of reserve ease in the present upswing, there has been no change in the discount rate since it was reduced twice as an anti-recession measure in the summer of 1960. In the comparable phase of the 1954-57 upswing, the discount rate had been raised once and in the 1958-60 upswing four times. To be sure, the discount rate was not reduced as low in the recent as in earlier recessions owing to balance of payments considerations, yet it has not impaired achievement of monetary ease. When reserves are being supplied to banks in ample quantity, borrowing is rarely necessary and little influenced by the level of the discount rate. On the other hand, the rate does seem to have some effect on yields of short-term Treasury bills, which are commonly utilized to adjust temporary variations in reserve positions of individual banks.

Growth in Bank Credit and Deposits

In response to this continued ready availability of bank reserves, commercial banks have been able to supply a large and continuing flow of new funds to credit markets through expansion in their loans and investments. During the past twelve months, total commercial bank credit

rose at an annual rate of 8.5 per cent. Member banks in the Atlanta District have participated fully in this recent credit rise, for your loans and investments have increased at the identical rate as the average for all member and all commercial banks in the country. In the previous cyclical upswings, commercial bank credit grew at an annual rate of only about 6.0 per cent, or about one-third less than this time.

The influence of reserve availability on the growth of bank credit can be illustrated even more effectively by subdividing these upswings so as to compare growth rates in the early phase, when an easy monetary policy was being observed in all three periods, with those in the later phase, by which time monetary policy in the previous two upswings had become restrictive. In the first seven months of the upswing, bank loans and investments rose at an annual rate of 7 to 9 per cent in all three cycles. However, in the last six months of the current period, the growth rate was 8 per cent, or one point higher than in the first seven months. In the two previous upswings, the rate fell to the 2 to 3 per cent range.

While the banking system, aided by a continuing ample supply of bank reserves, has been able to channel much more funds to credit markets in this upswing than in the previous two, it has provided less of these funds through loan expansion than formerly and more through acquisition of investments. In the previous two cycles, a marked upturn in demand for bank loans began within a few months of the cyclical trough. This time, it began later. In the six months ending in March, the pace of loan expansion at all commercial banks, after allowance for seasonal influences, was only slightly less than in the comparable months of the

1958-60 expansion, but it was considerably below that in the 1954-57 period, when demands for credit associated with large plant and equipment expenditures and consumer durable goods purchases were unusually strong.

On the other hand, banks have continued to add to their holdings of U. S. Government and other securities throughout the current period of economic expansion. By this time in the previous two cycles, with a large demand for loans and restricted growth in total credit, banks had begun to reduce their Government portfolios in order to continue to accommodate the loan demands of their customers.

The rapid expansion in bank holdings of municipal securities is particularly striking in the current cycle. These securities have increased at almost double the rate which prevailed in the previous two upswings. Moreover, the growth rate has accelerated markedly since the end of the year, when many banks raised their rates on time and savings deposits. In the first quarter of 1962, bank holdings of municipals increased at an annual rate of more than 25 per cent, or nearly double the rate prevailing over most of 1961. In the comparable months of the previous two cycles, holdings of these securities had shown little change. Since recent bank acquisitions of municipals are reported to be largely concentrated in longer maturities, they have provided some offset to the past year's liquidity rise in bank portfolios of U. S. Government securities.

Associated with the rapid growth in bank credit in the current period of business expansion has been an unusually rapid rise in commercial bank deposits, which have increased at an annual rate of close to 7 per cent.

Most of the deposit growth has been in time and savings deposits. They rose 13 per cent in 1961, but since the end of the year have been expanding at an annual rate of 25 per cent. Demand deposits, on the other hand, have shown only a small growth since the upturn began.

With banks experiencing somewhat less loan demand and greater growth in total credit in the current upswing than in the earlier ones, they appear to have retained adequate elbow room for further loan expansion. One indication of this is to be found in their loan-to-deposit ratios. While still relatively high compared with this stage of previous expansions, current ratios are slightly lower than they were at the end of the last upswing. Moreover, in view of large bank holdings of short-term Governments, any prospective problems of "lock-in" which might have been encountered in earlier upswings would now appear to be less likely. In addition, the recently increased proportion of total deposits in time and savings deposits, which are less volatile than demand deposits, suggests that current levels of bank liquidity may actually be more comfortable than the loan and liquidity ratios indicate. During this upswing, the ratio of time to total deposits at commercial banks has increased from 34 to 38 per cent; but I notice that in the Atlanta District the ratio is lower and has increased only from 28 to 30 per cent.

On the basis of these considerations, commercial banks appear to be in a good position to provide loan credit needed to accommodate further economic growth. Indeed, it would not be surprising if you bankers at this juncture are actively seeking ways to make borrowing more attractive. The recent rapid growth in total credit may help to explain why

some bankers have felt that loan demand in the current upswing has been weak. Relative to their total assets or total deposits, which have been growing faster than their loans, their loan ratios simply are not as high as they expected them to be at this phase of the cycle.

In conclusion, the continuation of a policy by the Federal Reserve of maintaining ready availability of bank reserves throughout the recovery and expansion period is a distinguishing feature of the current cycle. This policy has been made possible by another unique feature of this upswing: the continued absence of an inflationary environment and of speculative uses of credit. Commercial banks have responded to this policy of monetary ease by maintaining a large flow of funds to credit markets. Although bank loans recently have been expanding at a relatively rapid rate, the position of the banking system would certainly seem to assure continued availability of credit. The joint responsibility of the Federal Reserve and the commercial banks is to provide and properly channel the credit needed to assure sustainable economic growth.