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Recent Credit Trends in the U. S. Economy

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

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Nearly two decades have elapsed since the end of World War II and the U. S. economy is now showing respectable stability and growth. Reasonable price stability has been achieved in recent years, and growth has been well sustained since early 1961 in the longest expansion of the postwar period.

However, the more remote the growth-stimulative effects of war shortages and wartime liquidity accumulations become, the less certain it is that growth will be sustained at recent rates. Some economic forecasters and observers now hint that the current 4-year old expansion is cresting, becoming unsustainable for the usual reasons, or is being perpetuated by some type of structural stimulant which will shortly be diluted or neutralized. It is not my intention to review the cyclical posture of the U. S. economy today and present you with a near- or long-term forecast. Rather I would like to turn your attention to characteristics of our present-day economy which reveal evidences of stress or strength.

The techniques for checking out the nation's economic health and stamina are limited by our understanding of economic relationships or processes and by the facts that can be assembled to make that understanding usable. Not surprisingly, economists differ in their awareness of the facts and the way in which they should be employed to reach an economic diagnosis. And so there ensues a variety of advice, admonition, or assurance.

My intention is not to try to persuade you to anything but simply to share with you my own effort to look retrospectively at some aspects of our present economic situation, to see if hidden or evident stresses and strains exist which may make the economy's recent stability and growth record vulnerable.

Because such a task is far too extensive for a single luncheon speech I will limit my remarks today to an examination of some credit aspects of the economy.

Questions about the economy's ability to continue growing at present rates are often directed to the volume of funds being raised in credit and equity markets. The total has expanded in each year of the current upswing and is estimated to have reached $70 billion in 1964. Some fears that imbalances are developing in the economy relate directly to this continued growth and to the record level of credit outstanding. Others are concerned with changes in the pattern of saving and lending that have occurred in the present expansion as compared with earlier periods of economic growth. I will approach these questions by considering, in turn, the major sectors of the economy. What changes have, in fact, taken place in the role of households, corporations and the various levels of government as suppliers and users of funds?

<u>Households</u>. A very large proportion of the funds supplied in credit markets comes, directly or indirectly, from the savings flows of households. With personal income--and particularly income after taxes--increasing rapidly, household saving has expanded to record levels. Such savings may be used to purchase real capital goods--consumers durables and houses, to repay debts or to acquire financial assets.

The broadest measure of saving combines all these uses and is sometimes called "gross saving," since it does not take into account the fact that even durables wear out and ultimately have to be replaced. Gross saving, measured in this way, now amounts to about $100 billion and accounts for more than one-fifth of disposable income. This fraction has been nearly constant over the current upswing, and does not differ much from earlier years. Thus the first change in household saving to note is its record level, which can be attributed directly to the continuing growth of after-tax income.

The second change in household saving is that consumers have been adding to their financial assets relatively more rapidly than they have been building up equity in physical assets. Since 1960, consumer purchases of capital goods have not kept pace with the rise in income, despite the fact that the increase in household indebtedness has matched or exceeded income growth in all years except 1964. Thus the annual addition to consumers' equity in capital goods (as measured by current capital expenditures less the increase in household debt) has risen only from $50 billion in 1960 to $55 billion in 1964, and most of this increase was in the past year.

On the other hand, savings in financial form have grown more rapidly over the past 4 years than in earlier periods of rapid economic growth and have absorbed a higher proportion of income. Annual acquisitions of financial assets rose from a low of $24 billion in 1960 to $48 billion last year. And this represents new acquisitions only; it does not include appreciation due to the continuing rise of stock prices.

The third change in recent household savings patterns concerns the type of financial asset acquired. Households have entrusted a higher proportion of their savings to financial intermediaries. This development has several origins, but at least part of it simply reflects a longer term trend toward more intermediation in U. S. capital markets.

For one thing, a significant share of saving is not subject to any material extent to current decisions by households so far as amount and form is concerned. Inflows to insurance companies and pension funds are contractual, and individuals have only a limited opportunity, if any, to vary the amount they contribute. With a steady uptrend in such commitments, insurance and pension fund reserves have grown at a somewhat more rapid rate than income, and their increase last year added nearly $15 billion to the financial assets attributed to the household sector.

But the really outstanding development is the change that has occurred in savings in depositary forms--time and savings deposits at commercial banks and accounts at other savings institutions. This type of saving permits households to accumulate assets in convenient liquid form while institutions make funds available to longer term borrowers, and it has been subject to a continuing growth trend throughout the postwar period.

But this long-run trend cannot explain the recent explosive rise in depositary savings nor the way in which it has deviated from an established cyclical pattern.

In past cycles, the proportion of household saving taking depositary form has typically been highest in the early stages of the upswing because, at that stage, depositary rates have been more attractive compared with yields on alternative market instruments. Later, as demands for funds have risen and credit stringencies have developed, interest rates in the market have climbed more rapidly than depositary returns. At this later stage of expansion, rising household incomes have generated greater savings flows, but more of the increase has been directed toward purchase of market instruments.

During the current cycle, this sequence has been greatly modified. Market yields have risen less sharply than has often been the case in earlier expansions, while increases in depositary rates have kept such savings generally competitive with market alternatives. On the basis of previous experience, the sharp rise in depositary saving which occurred in 1961 might have been expected, but the even larger increase in 1962 would not. At the beginning of that year, however, the change in Regulation Q permitted commercial banks to increase their rates on time and savings deposits. Such deposits increased very rapidly, the portion held by households rising by $11.5 billion as compared with $6.8 billion the previous year. Other savings institutions also raised their rates, and in the ensuing vigorous competition for funds they continued to experience growing savings inflows.

In 1963 and 1964, the inflow of household savings to commercial banks readjusted to a somewhat lower level but remained much above inflows in earlier years. Moreover, flows to other savings institutions have continued to rise. Thus, although direct acquisitions of market instruments by households grew from less than $3 billion in 1961 to about $8 billion last year, they were still only one-third as much as the $24 billion added to household savings accounts of all types in 1964.

In sum, record incomes have permitted record levels of household saving. An exceptionally high proportion of these savings has taken financial form. And households have chosen to hold an exceptionally large share of this total as claims on financial institutions. The end product of these three developments has been an unprecedented flow of funds into capital markets through financial intermediaries.

Corporations. Corporations, like households, are both users and suppliers of credit, and in both respects their performance during the current economic expansion has differed to some degree from earlier postwar experience.

As compared with earlier periods of economic growth, corporations have been relatively less dependent on credit and equity markets for funds to finance business expansion and rising levels of activity. External financing--in such forms as security offerings, mortgage borrowing, and bank loans--has been substantial in absolute terms, but the rise over the course of the upswing has been unusually moderate relative to the growth in corporate output and income.

The degree to which corporations rely on external financing depends in large part on the extent to which they have funds available internally in the form of depreciation reserves and retained earnings. Both of these internal flows have been unusually high in recent years. Liberalized tax guide-lines have permitted more rapid accumulation of depreciation reserves. Profit margins, which usually decline as the expansion phase of the cycle generates bottlenecks and imbalances, resisted erosion--at least well into 1964--and tax reductions have increased the share of gross profit carried through to after tax income.

At the same time that internal funds have been unusually ample compared with earlier cyclical upswings, corporate domestic outlays on plant and equipment have risen somewhat less sharply than at some times in the past. In consequence, funds available from internal sources have continued--for the corporate sector as a whole--to exceed such capital outlays. Another element in the less pressing demand for funds, and particularly for bank loans, has been the very moderate rate of inventory accumulation. Unusually large sums, on the other hand, have been applied to such uses as granting increased trade credit to unincorporated businesses and consumers, and for direct investment abroad.

Holdings of financial assets, primarily liquid assets, have also been increased. This increase in liquid holdings has been significant in size but it does not represent a build-up in the relative liquidity of corporations. In fact, short-term liabilities and measures of transactions needs have grown faster than liquid asset holdings, so that conventional liquidity ratios for the corporate sector of the economy are at historically low levels.

More important than changes in the level of corporate liquid asset holdings have been changes in the form in which they are held. Corporations, like households, have shifted funds from direct investments in short-term Government and other marketable debt instruments to intermediaries--specifically to commercial banks in the form of negotiable certificates of deposit. In this, they have been influenced by the unusually favorable rate comparisons already noted, and their action parallels the actions of household savers in making a larger proportion of all funds available through financial institutions.

Government. Along with households and businesses, units of government at all levels are important participants in the credit and equity markets. As you know, State and local governments have done a record amount of market financing in recent years. For each of the past two years, the net increase in State and local obligations outstanding has amounted to $6.5 billion or more. Most of this growth has not been related primarily to the phase of the cycle. Instead, financing needs have roughly paralleled growth in the activities performed by local government units.

Government units below the Federal level have also become increasingly important factors in upplying funds to credit markets.

Much of this growth reflects the increase in reserves accumulated for retirement funds and other purposes, and like the need for long-term funds is not primarily a cyclical development. But changes in interest rate relationships have affected the behavior of State and local authorities in the financial markets in several significant ways.

Relatively low long-term interest costs, compared with returns available on short-term instruments, have led some units to refund high-coupon issues substantially in advance of the earliest call date and make the proceeds available for interim investment. This has augmented the total of liquid funds available, and, as in the case of other sectors of the economy, a higher proportion of these funds have been placed with banks in the form of certificates of deposit.

The role played by the Federal government in the present upswing contrasts with that followed in the two preceeding business cycles. In the course of the current upswing, the Government sector through fiscal policy has played a sustaining role in implementing the expansion in demand. In other recent periods of economic expansion, the Federal budget has moved from a position of deficit at the trough to one of substantial surplus during the expansion phase. The upswing which began in 1961, however, has been marked by a moderate continuing deficit. A small surplus developed toward the end of 1963, but was quickly reversed by the general tax reduction early in 1964. While Federal expenditures have risen more rapidly during the current expansion than in either the 1954-57 or the 1958-60 periods, fiscal policy has been exercised more importantly through changes in tax rates and structure.

The greater support furnished the economy in the current cycle by this continuing contribution of the Federal Government to aggregate demand has supplemented the relatively moderate growth in corporate investment outlays and consumer spending for capital goods into 1964. Thus, fiscal policy has been unusually appropriate, in view of the character of demands in the private sectors during much of the current upswing.

Implications

It seems to me that some important conclusions flow logically from the foregoing description of financial developments in the current economic expansion. These I would summarize as follows:

First, it is evident that saving has been at record levels in recent years, primarily reflecting high and rising personal incomes and business profits. Within the saving total, the flow of financial saving has grown more than proportionately, as a relatively weak private propensity to spend has been compensated by an expansive Federal fiscal policy. Indeed, savings flows at times have been so high that they have put long-term interest rates under downward pressure, and, in competing for investment outlets, lenders have had to liberalize their terms and standards of credit extension in order to remain fully invested.

Second, an unusually large part of this record total of financial saving in the current cycle has flowed through institutional intermediaries with commercial banks greatly increasing their share. Mainly responsible for the structural shift toward institutions in general and banks in particular have been the increases in interest rates available on such savings, following successive upward adjustments in Regulation Q ceilings, and the marked strengthening in the competition for savings among financial institutions. The counterpart of the increased role of banks as recipients of intermediated savings has been their greater relative importance in accommodating total credit demands in this expansion, compared with earlier upswings.

Third, the institutions--including the commercial banks--have used their enlarged inflows of interest-bearing funds to invest heavily in capital market-type assets, such as mortgages, municipals, and corporate and Treasury bonds. The expansion in such holdings partly reflects the increased flow of funds through traditional channels. But the higher cost of savings funds has put institutions under pressure to find higher yielding, and, in many cases, longer term assets, and, in addition, shifts in the portfolio composition of the commercial banks have reflected the presumably greater stability of savings as compared with demand deposits.

Fourth, the combined effect of increased competition for short-term savings funds, on the one hand, and for long-term investment outlets, on the other, has operated to compress the spread between short- and long-term yields. This has had the beneficial side effect, so far as our balance of payments has been concerned, of contributing to the rise in short-term rates while stabilizing the cost of funds to long-term borrowers. In this way, the growing intermediation of savings has helped reinforce the conduct of monetary policy in this period.

This summary of recent savings developments raises a number of important questions. One may ask whether we are saving too much in the aggregate and, even if not, whether too much saving is taking the form of claims on depositary-type financial intermediaries. Further, there is the question whether the intermediation process, in which institutions issue liquid claims and use the proceeds to acquire long-term assets, could under some circumstances prove disruptive to sustained economic growth.

Does our economy save too much? In the larger sense, gross saving as I used the term earlier has grown only at about the same rate as income flows. Within this gross total of capital investment, debt repayment, and acquisition of financial assets, it clearly would be incompatible with the goals of public policy to discourage current expenditures for business and consumer capital goods--plant, equipment, housing and consumer durables--or from saving through the repayment of debt.

Of the total savings flow into financial assets, a significant part is contracted for through insurance, pension and retirement plans. There would seem to be no good reason for interfering with these institutional arrangements, in which financial saving is only one element. The remainder of total saving may be used either to purchase market instruments or to acquire depositary-type claims on financial institutions. The way in which such saving is distributed depends on interest rate and other incentives and, in the case of marketable securities, interest rate changes can be relied on to balance supplies and demands.

In the long run, market forces also will tend to adjust rates of savings inflow to financial institutions. But there is considerably more danger that dislocations could occur before this outcome is reached. This reflects lags in response, competitive considerations, and the inclination of institutions to take all funds offered even though their utilizations might require a loosening in credit standards.

Against these dangers must be set the very real advantages to the efficient functioning of the economy which have accrued through the process of financial intermediation. The individual saver receives the benefit of an attractive yield with "instant" liquidity. And since the balancing of inflows and outflows of savings funds ordinarily can be counted on to lend stability to the level of deposits, institutions are able to make these funds available in a form suitable to borrowers in the capital markets.

The economy benefits not only from this mobilization of small savings, but also from the professional investment skills of institutional management. These advantages can best be realized when there are many competitive intermediaries at the local and national level to offset the danger of concentration of financial power. The increased effectiveness of bank competition in recent years has contributed to this objective, and also has had the advantage of placing funds with a highly diversified lender capable of choosing the most desirable investment outlets. One offsetting disadvantage under current circumstances and of a temporary nature is some probable worsening of the balance of payments drain. This results from the fact that banks engage in foreign lending more than other savings institutions because they are legally and technically competent to do so.

If, on balance, it is felt that the actual and potential disadvantages of intermediation on the scale of recent years outweigh the advantages, one remedy would lie in changing the rate differentials which have induced such growth. This could be done, so far as banks are concerned, by reducing the ceiling interest rates permitted under Regulation Q. Such regulatory action would dampen the flow of funds to these intermediaries and might well lead to some decrease in total financial flows as well. In effect, this would simply reverse actions which have encouraged the competition for savings over recent years.

It is my judgment that the advantages of intermediation vastly outweigh the hazards associated with borrowing short and lending long. And I am convinced that the overwhelming majority of institutional managements will serve both their own and the economy's long-run interests by setting adequate credit standards and, if necessary, limiting their savings inflows accordingly. If our economy is to expand with vigor and resilience, it must rely on innovation to meet emerging needs and not depend on aged guide lines to avoid obsolete perils.