Not to Press

CURRENT CREDIT AND MONETARY PROBLEMS

Remarks by Chas. N. Shepardson, Member, Board of Governors, Federal Reserve System, before the meeting of New Hampshire Bankers Association, Portsmouth, New Hampshire, on June 8, 1956.

It is a real pleasure to be with you this evening and to discuss briefly some problems of mutual interest. Cost and availability of money and credit have been in the forefront of the news in recent months. This development alone suggests the desirability of reviewing together some facets of this problem in which we are all interested and for the successful solution of which we are mutually responsible.

I should like to say a little about the recent policies of the Federal Reserve System and their effects. Before turning to these recent developments, however, let me comment briefly on the basic objectives of our monetary policy and the way in which we hope and expect that various measures will operate to achieve these objectives.

The basic function of the Federal Reserve System is to make possible a flow of credit and money that will foster orderly economic growth with reasonably stable prices. At times the level of expenditures may be either diminishing or expanding at a slower rate than the healthy growth of the economy would permit. This requires that we take actions which encourage the expansion of bank credit and the money supply and thereby both the rate and amount of consumption and investment expenditures. On the other hand, there may be a tendency for money, credit, and the level of expenditure in the economy to expand more rapidly than healthy sustainable growth would indicate. It is then clearly important that we do those things which are within our power to restrain the pace of expansion and thereby reduce the danger of inflationary developments and the sharp and painful adjustments in economic activity that may result from them.

The tools that we have to work with toward these ends are well known to you. Basically, they operate by influencing the availability and cost of additional bank reserves, encouraging or restraining, in turn, the total flow of credit and money in the economy.

Over the years there has been considerable discussion in Government and academic circles, among bankers and in financial markets, as to the effectiveness of these general instruments of monetary policy. No one, to my knowledge, has ever contended that general monetary measures, even if the timing and magnitude of their application were perfect, could completely moderate swings in business activity. Some observers, however, would attribute more potency to these measures than the facts of the situation justify.

The very nature of our economy, based as it is on innumerable and frequently conflicting human judgments and actions, precludes such a possibility. Furthermore, our entire universe is dependent on a system of more or less rhythmic pulsations. These produce inevitable and probably desirable variations in the rate or intensity of activity in different phases of our existence. Complete elimination of these swings in our activity can only be achieved, if at all, by the imposition of rigorous artificial controls. We have always abhorred such controls and, so far, largely avoided them except in cases of dire emergency. We have learned, however, to modulate the force of these pulsations both in our physical and our economic life.

It is to the achievement of this end rather than complete stability that our flexible credit and monetary policies are directed. I believe that even those who are most skeptical of the effectiveness of these measures would agree that they do make some contribution to reducing the range of economic fluctuations.

In recent years, the attitude toward general instruments of monetary policy seems to have shifted away from the negativism of the 1930's toward a more balanced appraisal of the important part that such policy can play in helping to achieve sustainable growth. Certainly among bankers, and I believe also among informed businessmen, union leaders, and farmers, there has recently been an increasing recognition that sound, flexible monetary and fiscal policies on the part of the Government and prudent, far-sighted management of private business are all essential parts of any program directed toward the most effective use of our resources. This is fortunate both for the present and future welfare of the United States and those nations which are associated with us in our efforts to demonstrate the effectiveness and desirability of individual freedom in economic affairs.

As I have said, we at the Board have a responsibility with regard to the general cost and availability of credit. We can do certain things which make credit generally easier or tighter. It is your responsibility, together with other bankers, to see that available supply of credit is prudently and economically allocated among the various demands. This task, it seems to me, is equally important and, if possible, even more difficult. In fact, the prudent and intelligent allocation of available credit in any quantity may be of more importance to our long-range economic welfare than the absolute amount of credit available. Certainly, when credit growth is subject to restraint and this restraint is reflected in rising interest rates and a limitation on credit lines to creditworthy borrowers, you can expect to have your decisions, like ours, subject to criticism from persons outside banking.

With this background, I should like to turn now to the current situation.

It is no secret that the Federal Reserve System directed its efforts toward credit restraint after the spring of last year. The results of these efforts have been widely discussed and commented upon and the casual reader might well gain the impression that these policy actions resulted in a sharp curtailment in lending activity. I am sure you all realize that this was not the case but I wonder if you have observed that, in fact, 1955 witnessed the largest expansion in the dollar volume of loans at commercial banks in our entire history -- amounting to about 11 billion dollars -- and so far this year loan expansion has been twice that for the same period last year. Furthermore, the volume of security flotations so far this year has been greater than the high level of last year and in recent months has been above previous peaks in 1952 and 1953. I mention these rather striking figures to emphasize that credit policy was not directed toward, nor did it accomplish, any reduction or even leveling of the volume of credit available to the private economy. What it attempted to do was to bring about some restraint on the rate of expansion. There was never any question that some growth in the volume of bank credit to meet the needs of our expanding economy is both necessary and desirable. The only valid limit on the rate of our economic growth is found in the emergence of inflationary pressures, resulting from an excessive rate of expansion and giving rise to maladjustments which lead to potentially serious reversals.

In recent months outlays for new plant and equipment have been running 30 per cent above a year ago and surveys of businessmen's expected spending indicate planning for continued increases in these expenditures. Furthermore, businessmen have continued to accumulate inventories, most of them apparently in connection with the capital goods boom. Publicity about business inventories has tended to emphasize the sharp increase in automobile stocks in the hands of dealers and overlook the fact that the major rise in inventories has been in the metal and metal products industries. This demand for industrial raw materials has been reflected in the increase in industrial prices, which are now 5 per cent above a year ago.

Therefore, if we can describe credit as "tight" in any sense, it must be in relative terms, i.e., that not every businessman has been able to get all of the credit he wants for every purpose. This is undoubtedly true. Some businessmen have had to tailor their plans to the availability of external financing. This raises, of course, the question of whether the loanable funds available to banks and other financial institutions have been and are being wisely and fairly allocated among competing borrowers. More specifically, there has been some discussion of whether small business is discriminated against in periods when credit demands outstrip the availability of saving. For this reason it seemed to me that it might be interesting and worthwhile to review with you the factual information we have on this point.

First of all, it seems to me, it is important to realize that most of the banks in this country are small businesses themselves. Nearly 85 per cent of our 13,700 commercial banks carry less than $10 million in deposits. The survey of business loans taken last fall, in which many of you gentlemen participated, shows that 80 per cent of the loans made by these small banks are extended to businesses with assets of less than $250 thousand. Only 5 per cent of their loans are made to companies with assets of over $1 million. Even if tight credit conditions have tended to make banks favor their best customers, the best and in fact the <u>only</u> business customers of most commercial banks continue to be small businesses.

The larger banks in our country, of course, lend mostly to larger industrial firms and, over the past year, our data indicate that most of the increase in loans at larger banks has been to their larger customers. This lending, however, has not been at the expense of the small customer. Our surveys on such matters indicate that even at larger banks the volume of lending to such customers has been maintained.

You may know of our quarterly survey of the new business loans made by large banks in 19 financial centers. We have been conducting this survey since 1949, primarily in order to follow the course of interest rates. The latest survey available, pertaining to loans made in the first two weeks of March, shows that over 80 per cent of the business loans made by these larger banks were for less than $100 thousand and averaged less than $18,000. Both the number and the aggregate dollar amount of the small loans made this March were as large as in March a year ago.

As far as borrowing costs are concerned, the data show that although rates have increased on all sizes of loans, the rise has been sharpest on the large loans. Differentials between rates on large and small loans have narrowed considerably. In summary, our survey would indicate that banks have not penalized their smaller customers by curtailing their loans or by raising the costs of borrowing disproportionately. While smaller companies have not expanded their bank indebtedness as much as the larger ones this year, they have not been deprived of the large volume of credit available to them last year.

You may have also heard that, in this period of almost unprecedented prosperity, many small businesses are going bankrupt. Frequently, the inference is drawn that inability to obtain necessary credit is the principal cause of such failures. While we cannot say what are the most important underlying factors in the failure picture at any one time, we can look at the figures to see how many businesses have failed this year and what kind of businesses they have been.

The Dun and Bradstreet data on business failures show that, in the first four months of 1956, 4,200 concerns went out of business with some loss to creditors. This is one-eighth more than in the same period of 1955 and represents an annual seasonally adjusted rate of about 45 failures per 10,000 going concerns -- about the same rate as in late 1954. Though this is well above other postwar years, it is far below the failure rate in the immediate prewar years.

It is true that the sharpest increases in failures this year have been in the construction and retail automotive groups -- industries whose current troubles, in my opinion, have not developed primarily out of recent credit stringency. The available data on business failures do not show any concentration of bankruptcies among the smaller firms.

What we can glean from the available statistical information would seem to suggest that there is at least no preponderance of evidence that small business is discriminated against in a period when credit growth is under some restraint. While this is reassuring, it should not cause us to dismiss the possible problem or to be complacent about it. As I indicated earlier, the responsibility for allocating the over-all supply of credit among the various competing borrowers rests with commercial banks and other private lending institutions. It is the responsibility of you and your colleagues to see to it that the loanable funds available to you are directed to those uses which will best serve the interests of the whole community. In a free competitive system, we necessarily rely on the operation of the normal changes in supply and demand and the price fluctuations which they reflect to allocate our resources among various competing uses. As you all know, however, particularly in the field of credit, judgment plays an all-important role. Your collective decisions as to the relative creditworthiness of various competing borrowers and the points at which various undertakings should be encouraged or discouraged in their requests for credit accommodation quite literally shape the future of our country.

In this connection, there is only one point that gives me some concern. It is frequently stated that creditworthiness is often determined by past record of performance and that new enterprises with little or no past credit record are thus automatically discriminated against in favor of old established customers. Certainly, it is to be expected that old customers will and should be given due consideration. On the other hand, we should never overlook the fact that in the kaleidoscope of our economic community there is an ever-changing pattern and that with the normal attrition of all human institutions the life blood of tomorrow's business may flow from the untried newcomer of today. We all know that the farmer with a short crop must set aside a portion of his harvest for seed -- even at the expense of other current needs -- if he would stay in business. Similarly,we must be alert to the importance of setting aside a prudent portion of available credit to meet the needs of promising new enterprises which have in the past and will in the future provide the youthful vigor, imagination, and enthusiasm so essential to the continuance of a growing, dynamic economy.

As I stated in the beginning, the basic function and objective of the Federal Reserve System is to provide the money and credit essential to an orderly and sustainable growth in the economy while maintaining a reasonably stable level of prices. Our success in achieving this objective lies in no small measure in the wisdom and prudence with which available credit is allocated. While I have avoided burdening you with a mass of figures, the fragmentary statistics which I have presented would seem to justify my confidence in the willingness and ability of bank officials to do this job. This, then, leads me to the conclusion that such credit growth as the productive capacity of our economy will safely permit,will continue to be directed toward those uses which will contribute most to the further sound development and prosperity of our country.

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