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THE FOUNDATIONS OF A LASTING RECOVERY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

84th Annual Convention of
The Illinois Bankers Association

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Chicago, Illinois

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I am delighted to have the opportunity to address members of the Illinois Bankers Association on the topic of "The Foundations of a Lasting Recovery." These foundations must now be put in place. The future will depend decisively on what happens in the economy in the next few months, on the actions of the administration and the Congress with respect to the budget, those of the Federal Reserve with respect to money and credit, and the functioning of the banking system in channeling credit to households and businesses. These are the principal topics to which I would like to invite your attention.

The economy, after a rapid slide, now appears to be bottoming out. Various straws have appeared in the wind, although not all of them as yet pointing in the same direction. We shall probably have to live with crosscurrents and conflicting signals for a while longer. But there are good reasons for the growing confidence that I sense around the country.

One reason for this confidence is that inflation has begun to ease off. That has made it possible for interest rates to come down. If people can be confident that inflation will continue to subside, a strong force in favor of moderate interest rates will be at work. Consumers also appear to be taking heart as food prices and other prices begin to show signs of greater stability. Progress against inflation has not been nearly enough, but a good beginning has been made. On this basis, there is better hope for success in the most immediate task of economic policy -- to reduce unemployment. Instability of prices has proved itself to be the enemy of stability of jobs. For every job that inflationary finance might create temporarily, there are two that it destroys afterwards. If we want steady jobs, we need a steady economy, not one subject to the excesses and deprivations of inflation.

The growing confidence that recovery lies immediately ahead is reflected in the forecasts that continue to make their appearance. A turning point around the middle of the year has long been a favorite forecast. As the recession deepened, it would not have been surprising to see forecasters postpone their chosen date. This, so far as I am aware, has not happened.

One reason is that the economic slide, which for a while was moving at an alarming rate, has revealed itself to be of a kind with which we have become acquainted in years past. Inventories have been used up at a rapid rate and that has slowed production. But inventory liquidation supplies also the makings of a turnaround. If retail sales are reasonably well maintained, as they have been, production will have to pick up to match sales.

The looming deficit in the Federal budget also contributes to the forces of expansion. I do not believe, however, that it contributes to confidence. If anything, the prospect of a deficit that could exceed $100 billion is creating widespread concern. If the deficit is not kept under control, it will cause the economy to take off with a bang only to come down later with a thud. And excessive government spending will do other kinds of damage that may prove even more painful in the longer run.

We have heard a lot about the "crowding out" effect of the prospective budget deficit in our financial markets, so I will not address myself to it. There is another kind of crowding out, however, that the budget threatens to set in motion and it is the crowding out I believe to be the most important. This is the crowding out of productive investment in favor of unproductive consumption. Heavy taxes shift income from the producer to the nonproducer. They take away resources that should go into the creation of more jobs and more output and shift them into expenditures that an economy like ours -- hard pressed economically and politically around the world -- can no longer afford. Our taxing and spending policies shift resources from the private sector, which has been the strength of the American economy, to the public sector, whose past accomplishments provide little reason to expect efficiency and productivity. This is the crowding out that should concern us with a view to the long run. The evidence had already been imprinted on our economy in the form of declining investment, declining productivity and a shrinkage in profits -- profits needed to sustain both investment and productivity.

What role will the banks play as the economy moves toward and into recovery? The pressures to which the banks have recently been exposed must be expected to influence their future lending policy. Where liquidity has become insufficient, bank management will want to rebuild it. Bank capital, too, needs strengthening in many instances. This view has been expressed by the Federal Reserve Board, and has been underscored by the Board's policy, put into effect at mid-1974, of requiring a pause in the rapid expansion of bank holding companies. But quite independently of regulatory suggestions and actions, many bank managements today seem to believe that their institutions would benefit from the stronger capital position.

Many banks could lend more freely if they had stronger capital positions. In the long run the raising of capital through equity issues will be an important means to that end. For the time being, however, the state of the equity markets may make that route nonnegotiable for many equity seekers. Subordinated debt is an alternative answer. The Federal Reserve Board is now examining the possibilities that this alternative route holds out.

Some recent plans for the issuance of subordinated bank debt have encountered difficulties under the disclosure requirements of the SEC. The SEC's function is to protect the investor. It is useful for bank regulators to be reminded that it is not only the depositor, but also the stockholder and bondholder who ought to benefit from bank regulation. At the same time, banks clearly differ from other types of business enterprises. They are the custodians of the nation's monetary system. Their credit operations are essential to the national economy. Their solvency depends upon the maintenance of public confidence to a degree not equalled by other forms of business. For all these reasons, banks are regarded as being affected with the public interest and are severely regulated, supervised, and periodically examined in great detail.

Precisely because these examinations have to be rigorous, the assets of banks are looked at by the examiners and criticized in a manner that, to an outsider, might convey an erroneous idea of the bank's prospects of collecting on them. And the habit of present-day financial markets to group institutions and their liabilities into "tiers" could do considerable damage to particular banks, to their depositors and their debtors, if the publication of examination reports were to give rise to such discrimination among banks by large depositors. Damage would be done also to the American economy if failure to work out a reasonable compromise between the needs of bank customers on one side and of bank stockholders and bondholders on the other side cannot be achieved.

In addition to the raising of new capital, however, there is another route by which bank depositors can be protected. I am referring to deposit insurance, which already has proved its tremendous worth to the American banking system and its users.

Deposit insurance is a cheaper way of protecting the depositor than bank equity or subordinated debt. The cost of capital is high, whether it is paid in the form of dividends or of interest. The cost of deposit insurance, at any conceivable rate, would always be comparatively modest. Bank capital is a form of self-insurance -- the setting aside of funds to meet losses that are unlikely but could be large. Deposit insurance reflects a pooling of risks, analogous to fire and casualty insurance, and is a more economical way of achieving protection. As the American banking system evolves, I would like to see increasing emphasis on the insurance principle rather than the capital principle as a means of protecting depositors. I would not advocate full insurance of deposits -- that would not be conducive to sound banking. But further increases in the level up to which deposits are fully insured, the process by which over the years we have reached an insured level of $40,000, seem desirable. In addition, we might contemplate the possibility of insuring larger accounts up to some percentage of their total amount. This would leave a part, possibly a small one, of each account at the depositor's risk, which would give him a motive to scrutinize his bank carefully, as presumably he is doing now. An appropriate adjustment in the premiums paid to the insurer would complement arrangements of this kind.

It implies no criticism of our banking system, or of its form of regulation and of insurance, to say that they are capable of improvement. The banking system will have to change if it is merely to stand still, that is if it is to retain its share in the total volume of credit. I believe that our economy will recover faster and more lastingly from the present recession, and that its prosperity over the years will be more firmly assured, if an important part of the total flow of credit flows through the banking system. A bank's ability to adjust to the individual needs of its customers, its ability to stay with the customer in bad times, its role as a fallback when other sources of credit flow less freely, make banks particularly useful citizens among the vast array of lenders. As bankers, you contribute to this important function. You have reason to be proud of past achievement as well as eager to meet new challenges.

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