For Release on Delivery
Approximately 9:30 a.m.,
Eastern Daylight Time,
Monday, September 28, 1964)

BORROWING SHORT AND LENDING LONG

Remarks of C. Canby Balderston,

Vice Chairman,

Board of Governors of the Federal Reserve System,

Before the Fiftieth Annual Fall Conference
of the Robert Morris Associates,

in Montreal, Canada,

on Monday, September 28, 1964.

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BORROWING SHORT AND LENDING LONG

Walter Bagehot once said that a man became a banker when he was able to tell a note from a mortgage and that adventure is the life of commerce but caution is the life of banking. 1/

My title describes the essential nature of banking. From its very beginning banking has involved balancing the obligation to make immediate payment when called upon against the desire to earn maximum returns on lending and investing. Some loans and investments obviously have to be short to meet uncertain depositor demands while others can be stretched out over time for the sake of richer returns. Thus, the art of banking is to achieve and keep a balance between prudent safety and lucrative risk.

This balancing act is not peculiar to commercial banking. It is a problem for business firms of all types. In addition, the Federal Reserve System, as the central bank of the U. S., has a balancing act of its own. It is to supply to the commercial banks a volume of reserves that is neither too large nor too small. These reserves influence the amount of credit that banks can create to supplement the flow of savings from savers to borrowers. Since the volume of bank credit needs to be kept attuned to the needs of the economy, as they grow over time and fluctuate with the seasons and with the business cycle, the central bank has the continuous problem of determining the quantity of credit really needed for constructive purposes. Hence the Federal Reserve should supply enough reserves for healthy economic growth but not so much as to induce speculative excesses.

1/ See Lombard Street, pages 220-1; also quoted by Gerald T. Dunne, General Counsel of the Federal Reserve Bank of St. Louis, in "Business Horizons," Vol. VI, No. 4, of the Graduate School of Business, University of Indiana.

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Money and credit are viewed in different ways by different people. All might agree that credit is the lifeblood of an industrialized economy. From this point on, ideas diverge on what is the right blood pressure for an active economic body if it is to have endurance and continuing health. Borrowers traditionally have felt that the greater the pool of money and credit, the more readily and cheaply they can borrow. Whatever the quantity may be at a given time, they somehow feel that more would help them. That this reaction is widespread is evidenced by the political support for easy money in other times and countries. It is only when the supply increases fast enough to send prices spiraling upward that those who have basked in the warm glow of "easy money" find that they have been deceived. The stimulant that felt so good at first, and that may in fact have been helpful, will if injected into the blood stream too fast and too long lead in the end to inflationary habits difficult for a nation to break. Witness the struggles to this end going on right now in certain other countries.

In recent years, expansion of the United States economy has been accompanied by, and financed in part through, mammoth increases in private indebtedness. The nonfinancial sectors of the economy obtained $59 billion of credit during 1962, $64 billion during 1963, and about $69 billion, at annual rates, during the first half of the current year. We are fortunate that, in this country, the allocation of these huge sums is determined by the higgling of individual borrowers and lenders in credit markets. As a result, money and credit tend to flow toward those borrowers whose needs are reflected in their willingness to bid the most. But bidding for credit accommodation is not a mere matter of price or rate; lenders must consider returns from loans in relation to risk. Each lender is continually faced

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with the problem of balancing the need to venture his capital, if he is to make it fruitful, with the need to minimize risk if that capital is not to be impaired or lost entirely. How far to venture and still be prudent is his perennial concern. The decisions he makes require courage, detachment, and a high degree of competence.

Lending institutions must also consider that the ebb and flow of general business conditions, as well as the soundness of borrower projects, influence loan quality. During much of the period since World War II, rising prices and values and a generally favorable economic environment have salvaged many a loan or investment that otherwise would have turned sour. As has often been said, a lender never intentionally makes bad loans--they just go bad afterward. While the individual lender or borrower has no control over general business conditions, he must still attempt to take them into account.

The large increases in private indebtedness in recent years bear importantly on such planning. It is evident that we have an economy that generates a huge volume of savings. High and rising incomes and the desire for personal financial security combine to produce each year a large volume of deposits, insurance and pension fund commitments, and security investments. In turn, these funds must be employed, largely through the extension of credit, if they are not to exert a dampening effect on the economy.

From these considerations stem two basic questions. The first is whether private borrowers will continue to have the capacity to use this large volume of savings for productive purposes. The second and closely related question is whether the growth of total private debt has been, and will continue to be, administered in a way that maintains reasonable credit quality. If the answer to either question is negative,

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the credit situation could be inimical to financial stability and to the health of the economy.

Some light is thrown on the problem by the historical record on the volume of private debt, its distribution by type of credit and type of borrower, and the relationship of debt to the capacity to service it. At the end of 1963, total private debt owed by consumers, nonfinancial businesses, and farmers had climbed to about three-quarters of a trillion dollars. It had doubled in less than twelve years and multiplied six times since the end of World War II.

At first glance, these increases are startling and somewhat disturbing. Back in 1888, however, the opposition party in Congress--I'll leave it to you to guess which one it was--was complaining that Federal expenditures had reached the unprecedented figure of $1 billion in a peacetime year. To this, the then Speaker of the House of Representatives, Thomas Reed from Maine, answered, "It's a billion-dollar country. He made a key analytical point. In appraising the size of debt burden, comparison should be made not only with debt totals of the past but also with national output, income and savings.

The most useful overall yardstick for comparison is the Gross National Product. If total private debt is measured against the size of GNP, we find that such debt did rise sharply from 65 per cent in 1945 to about 130 per cent of GNP in 1963. But the 1963 percentage--at 130--was still well below the 162 per cent of 1929, the 146 per cent of 1900, the 152 per cent of 1912 and the 160 per cent of 1922. In short, even the huge postwar increases in private debt have not yet fully offset the decline relative to GNP that occurred during the Great Depression and World War II.

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It is true that a larger proportion of national output than before the War is absorbed by taxation at all levels of government, and hence is unavailable for servicing private debt. But even if related to private incomes after taxes, private debt is relatively smaller than it was in the 1920's. In other words, the sixfold expansion of private debt since the end of World War II was not a breakthrough to unprecedentedly high levels relative either to GNP or to after-tax income. Rather, this expansion has represented a process of catching up.

Having reached the conclusion that total private debt is not immoderate relative to incomes, we still find it necessary to examine its distribution by types of borrower and of loan. In a free economy, one man's income cannot be commandeered to service another man's debt. And the distribution of debt by type--including its maturity--is relevant to the quality of the assets securing it and to the interest and amortization burden implicit in the debt level.

Consumer Debt

The outstanding change in the composition of debt since the 1920's has been the rising share owed by consumers--residential mortgages, instalment debt, and other obligations of a consumer nature. Total consumer debt was less than a fourth of all private debt in 1929, but by 1963 it had climbed to 35 per cent. While total private debt was lower in 1963 than in 1929 in relation to GNP, the same yardstick shows markedly higher debt owed by consumers. Between these dates, total mortgage debt rose by about six times, home mortgage debt by six and one-half times, and consumer instalment credit by ten times.

The growth of home mortgage debt has been particularly rapid during the past five years. From 1958 through 1963, mortgages outstanding

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on 1 to 4 family homes rose by $65 billion, and in the current year the total amount outstanding will approach $200 billion. But despite this sharp rise in borrowing, institutional competition to get mortgages has been so vigorous that mortgage yields have dropped both absolutely and relative to yields on other long-term investments. From the postwar peak reached at the end of 1959 to the spring of 1963, FHA secondary market yields on home loans fell by 80 basis points, and conventional mortgage yields by 50 basis points. Though yields have recently leveled off, there has been some further relaxation of mortgage terms,--perhaps not always within the bounds of prudence.

For example, funds are widely reported to have been obtained by the refinancing of old mortgages, including borrowing on open-end mortgages, for such diverse purposes as vacation travel, and the purchase of household equipment. Of course, some borrowing for all of these purposes is undoubtedly sound. If the borrower's income plus net worth offers substantial coverage of the loan and its servicing, the particular use to which the borrowed money is put may not concern the lender. But there is still a presumption against <u>mortgage</u> borrowing for buying consumption goods or for other short-run purposes. And so, such loans should be of better than average quality.

Recent surveys of consumer finance also point to other specific areas of weakness in home mortgages and instalment debt. In a 1962 survey, it was found that such debt was highest, relative to income, among families in the $5,000-$7,500 income class. Roughly one-fifth of all home-owning families in this class had monthly mortgage payments in excess of 20 per cent of total family income <u>before</u> taxes quite apart from their

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instalment debt repayments. The large number of personal bankruptcies today is evidence of the consequent strain upon family budgets.

But in spite of certain areas of credit weakness, the overall capacity of consumers to meet their debts still appears good. The burden of consumer debt is much less than one might infer from historical comparisons of debt and income for the following reasons:

First, since the 1920's after-tax real income per person has risen sharply. Consumer ability to save and to service debt has thus risen at a rate faster than income. This is true even after allowing for an upgrading of what are generally felt to be "necessary" standards of consumption.

Second, the burden of consumer mortgage and instalment debt is more properly measured by interest and amortization payments relative to income, than by debt outstanding relative to income. And since the 1920's, these payments have risen much less than debt outstanding, because of the lengthening of maturities of both mortgage and consumer debt. As Raymond Saulnier has shown, of the mortgages made by 24 leading life-insurance companies between 1925 and 1929, two-thirds were for maturities of under 10 years. Today, much longer terms are readily available; even taking into account those instances where relatively short maturities are desired, the average contract term of mortgages now being made is well in excess of 20 years. As for instalment debt, data for a group of leading sales-finance companies indicates that average maturities on new and used-car credits have more than doubled since the 1920's. Longer contracts in both credit areas mean that monthly payments are reduced relative to outstanding loan balances. There is a limit to the stretching out of terms, however, since interest payments and lender exposure to changes in collateral value mount rapidly with the passage of time.

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Third, the near-universal practice of amortizing mortgage and instalment debt has spread the burden of payments much more evenly among borrowers. While amortized mortgages were by no means uncommon before the Great Depression, the bulk of single-family residential mortgage debt was still of the "balloon payment" type. Today, periodic repayments on mortgage debt are made by nearly all mortgage debtors and are geared to their incomes.

A fourth element of strength is the relative decline in security credit since the 1920's. This has reflected greater prudence on the part of lending institutions and borrowers, as well as the regulation of stock market credit by the Federal Reserve Board.

Finally, as real income per person has risen, consumers have purchased more durable goods and better housing out of each dollar of income. There has taken place some substitution of consumer-owned for business-owned capital goods. Thus, individually-owned automobiles have partly replaced business-owned busses and streetcars; and single-family homes have been substituted for rented apartments. As a result, the heavier burden of consumer debt has been offset in part by a lighter burden of business debt. And insofar as purchases of automobiles and appliances have reduced the needs of consumers to make current outlays, the ability of consumers to service debt out of income has been improved.

Business Debt

The declining proportion of business debt to all private debt is not just the consequence of greater borrowing by consumers. Since the 1920's, for example, corporate debt has also fallen substantially relative either to total GNP, or to that part of national income originating in corporate business. This favorable long-term trend has been caused

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largely by the growth of financing from internal sources--retained earnings and depreciation--expecially in the last decade. Another cause has been a long-term downward trend in real capital requirements per unit of manufacturing output.

In addition, there have been favorable changes in the composition of corporate debt and the assets securing it. The growth of term lending by banks and other financial institutions has helped to discourage the practice of borrowing on short-term unamortized notes to provide plant and equipment, and permanent working capital. Public-utility debt is of better quality because of the disappearance of pyramided holding companies. Despite increased borrowing, current assets of nonfinancial corporations have remained stable over the past six years relative to their current liabilities.

But against these favorable tendencies must be set the apparent large growth of trade debt owed by unincorporated businesses. Calculations made by Federal Reserve staff members show that such debt has grown not only in absolute amount but relative to the business done by individuals and partnerships. As yet, this trend is not alarming; bad debt losses have been rising, but are still within tolerable limits. Moreover, estimates of accounts payable broken down by industry do not suggest any unusual concentration of trade debt in particular lines. But the very short maturity of this business debt, and some evidence of the overextension of credit to business customers who are financially weak, give reason for watchfulness.

Another type of rapidly growing business debt is that on income-producing real estate. Mortgage credit on these properties has recently been increasing at an even more rapid rate than that secured by small

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homes. This growth has reflected in part the recent construction boom in apartments, hotels and motels, office buildings, and similar properties. From mid-1954 to mid-1964, for example, outstanding construction and permanent mortgage loans secured by multi-family and commercial properties have nearly doubled. New lending of this type, net of repayments, rose sixfold between the same two dates.

Ability to service long-term mortgage debt on income-producing properties usually reflects the operating fortunes of a special type of business enterprise engaged in marketing the short-term use of space at an immovable address. This ability depends on the uncertain course of a type of demand that has historically been more changeable than the supply of properties, and it is this interplay between supply and demand that determines rents. In addition, expenses of operation tend to increase as structures age. Judged from limited evidence, net operating income generated by certain types of rental properties and available for debt service has been recently below expectations based on earlier postwar experience and special Federal income-tax provisions. Therefore, debt on income-producing properties bears watching, particularly in view of the below-average experience of creditors after the end of the construction boom of the 1920's.

Conclusion

With the possible exception of some instances of overextension of trade credit and financing in the income-property mortgage field, business debt appears to be of generally good quality. Because of structural changes in types of debt and rising consumer incomes, the mortgage and instalment debt extended to consumers in recent years also seems satisfactory, on the whole, despite its great expansion. Cases of overheavy borrowing

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are numerous, but many consumers in every income bracket have debt that is negligible in relation to their income and assets. The continuing rise in consumer incomes suggests that borrowing can continue at or near past rates without necessarily impairing the quality of credit. But the verb "can" is used intentionally. The potential for further extensions of high-quality credit is considerable. But the potential for unsound extensions is also large.

For this reason I must end with mere exhortation rather than exposition. Loan officers of banks and other financial institutions have a unique responsibility to protect the quality of credit and thus the safety of the funds entrusted to them. It is a major governmental objective to provide the base for the prudent expansion of credit that is needed to absorb the current and expected future growth of financial savings. Techniques available for this purpose include the appropriate conduct of monetary policy, the setting of tax and spending rates that promote growth without inflation, and the encouragement of sound competition among commercial banks and other financial institutions. But the governmental sphere of action is limited to fostering the conditions for growth. Only credit officers have the knowledge of individual borrowers needed to judge their character, and to assess other circumstances that might affect the quality of credit adversely. Maintaining that quality is your responsibility to your depositors and to the economy.

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TABLES ACCOMPANYING SPEECH, "BORROWING SHORT AND LENDING LONG", DELIVERED BY C. CANBY BALDERSTON OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, TO THE ROBERT MORRIS ASSOCIATES ON SEPTEMBER 28, 1964 AT MONTREAL, CANADA

(These tables were prepared by Paul McGouldrick of the Capital Markets Section, Board of Governors.)

Table 1

Total Private Debt, Gross National Product, and Debt* to GNP, 1900 to 1963

Year	Private Debt (billions of $'s)	GNP (billions of $'s)	Percent of Private Debt to GNP
1900	27.3	18.7	146
1912	55.8	36.7	152
1922	110.8	69.3	160
1929	169.5	104.4	162
1933	131.3	56.0	224
1939	115.3	91.1	127
1945	138.3	213.6	65
1955	394.5	397.5	99
1963	752.8	583.9	129

* Sources of data in all tables are described on page 4.

Table 2

Total Private Debt by Major Types, 1929 to 1963
(Selected years, in billions of dollars)

Year and Origin of Estimates:	(1) Total debt	(2) Selected components: (a) Mortgage debt	(b) Consumer credit	(c) Trade debt	(d) Bonds	(e) Loans
A. Goldsmith estimates:						
1929	169.5	46.5	6.9	20.4	38.1	29.6
1933	131.3	38.2	3.4	14.5	37.7	13.0
1939	115.2	35.5	7.6	16.2	32.5	9.5
1945 (old estimate)	134.2	35.6	5.8	21.0	25.9	18.1
1945 (new estimate)	138.2	35.5	5.7	24.4	23.6	16.2
1950	247.1	72.9	21.8	42.4	36.1	26.3
1955	394.5	129.9	39.4	65.6	53.7	39.5
1958	495.2	171.9	46.1	81.9	69.7	54.5
B. Department of Commerce:						
1945	140.7	35.5	5.7	. . .	23.5	15.8
1958	499.1	171.9	45.1	69.7	68.4	61.3
1960	589.2	207.1	56.0	78.2	74.9	76.1
1961	633.3	225.8	57.7	84.1	79.1	80.0
1962	689.0	250.5	63.5	87.0	83.2	87.4
1963	752.8	281.0	69.9	93.6	86.9	96.4

Table 3

Total Private Debt by Sectors of Indebtedness, 1929 to 1958
(selected years)

<table>
<tr><th></th><th>Total</th><th>Consumers and nonprofit organizations</th><th>Farms</th><th>Nonfarm unincorporated business</th><th>Nonfinancial corporations</th></tr>
<tr><td>A. Amounts (in $ bil.):</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>1929</td><td>169.5</td><td>41.8</td><td>14.6</td><td>16.8</td><td>96.3</td></tr>
<tr><td>1933</td><td>131.3</td><td>29.3</td><td>10.4</td><td>12.0</td><td>79.5</td></tr>
<tr><td>1939</td><td>115.2</td><td>30.0</td><td>9.6</td><td>9.6</td><td>66.1</td></tr>
<tr><td>1945*</td><td>134.2</td><td>31.8</td><td>7.6</td><td>10.9</td><td>83.9</td></tr>
<tr><td>1945**</td><td>138.3</td><td>30.5</td><td>7.7</td><td>11.9</td><td>88.2</td></tr>
<tr><td>1955</td><td>394.5</td><td>137.1</td><td>17.0</td><td>32.7</td><td>207.7</td></tr>
<tr><td>1958</td><td>495.2</td><td>176.3</td><td>20.9</td><td>40.8</td><td>257.1</td></tr>
<tr><td>1963</td><td>752.8</td><td>273.1</td><td>29.3</td><td colspan="2">450.4</td></tr>
<tr><td>B. Per cent of total by sectors:</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>1929</td><td>100.0</td><td>24.7</td><td>8.6</td><td>9.9</td><td>56.8</td></tr>
<tr><td>1933</td><td>100.0</td><td>22.4</td><td>7.9</td><td>9.1</td><td>60.5</td></tr>
<tr><td>1939</td><td>100.0</td><td>26.0</td><td>8.3</td><td>8.3</td><td>57.3</td></tr>
<tr><td>1945*</td><td>100.0</td><td>22.1</td><td>5.6</td><td>8.6</td><td>63.8</td></tr>
<tr><td>1955</td><td>100.0</td><td>34.8</td><td>4.3</td><td>8.3</td><td>52.6</td></tr>
<tr><td>1958</td><td>100.0</td><td>35.6</td><td>4.2</td><td>8.2</td><td>51.9</td></tr>
<tr><td>1963</td><td>100.0</td><td>36.3</td><td>3.9</td><td colspan="2">59.8</td></tr>
</table>

* Old series, in Table 2, panel A.
** New series, in Table 2, panel A.

Notes to Tables:

(1) Total private debt (Tables 1, 2 and 3). The Goldsmith estimates, from 1900 to 1958, are the sum of total liabilities of the nonfarm household, agriculture, nonfarm unincorporated business, and nonfinancial corporate sectors described in A Study of Saving and Studies in the National Balance Sheet of the United States. Figures are from tables 1 and 1a of the latter work. Because of some differences between 1900-1945 and 1945-1958 estimates, those on both bases are given for the year 1945. Goldsmith and his associates have not prepared estimates for year subsequent to 1958.

The Department of Commerce estimates of total private debt are those published annually in the Survey of Current Business. For all years, the figures cited are based on the net debt concept described in the October 1950 Survey.

(2) GNP, 1900 to 1963. Estimated by the Department of Commerce (National Income Division) back to 1929. Before 1929, estimates are by John Kendrick, and Simon Kuznets. Estimates for 1900 and 1912 were interpolated among the Kendrick-Kuznets 5-year averages.

(3) Types of debt (Table 2). (a) Goldsmith estimates for 1929-to-1958 are from panel III of Tables 1 and 1a, Studies. . . . (b) Adjusted Department of Commerce estimates (section B of Table 2). Total debt is the same series as is shown in Table 3 and described under (1) above. Mortgage, consumer, bond, and loan debt are respectively tables 27 and 28 (mortgages), 29 (consumer credit), 25 (bonded debt,) and 30 and 31 (bank loans n.e.c. and other loans) in the 1963 Supplement to Flow of Funds Accounts, 1945-62 (Board of Governors of the Federal Reserve System). Trade debt was estimated from unpublished data excluding accounts and notes payable of financial corporations, and from flow of funds estimates of trade debt owed by the farm, household and unincorporated business sectors.

(4) Debt owed by sectors (Table 3). Goldsmith sectors (see above) are used from 1929 to 1958. The 1963 estimates were prepared as follows. Total debt is the same Commerce Department estimate as in Tables 1 and 2. Consumer and farm debt are their total financial liabilities in the flow of funds accounts for 1962, with net changes added to form the 1963 estimates. Debt of nonfinancial corporations and unincorporated business is a residual: the difference between total debt and farm plus consumer debt.