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THE FINANCIAL ENVIRONMENT FOR RECOVERY

Remarks of

Philip E. Coldwell

Member

Board of Governors

of the

Federal Reserve System

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The Financial Environment for Recovery

Many economists and economic commentators now seem convinced that the nation is at the bottom of the recent economic recession. This does not mean that recovery will get under way immediately nor that there will be a rapid upswing in activity, but at least the downward pressures appear to have spent themselves and now we should concern ourselves with the timing, pattern and speed of recovery. From present visibility, these elements of the recovery are far from clear.

To evaluate the prospects for recovery, we need to look at the strengths and weaknesses in our current economic patterns. Primary strengths reflect inventory liquidation spurred by consumer buying support and reduced production, improved housing credit providing possibilities of increased construction, rising consumer confidence as evidenced by the improvement in the stock market, and the improved financial institutional liquidity which augurs well for the future of credit availability in this nation.

On the other hand, certain material weaknesses or uncertainties are still in the picture. For example, it is still unclear as to the rate of housing construction because the price of housing has advanced so rapidly that many Americans cannot afford new housing. Similarly, basic durable goods demand has shown only faint signs of revival. Some improvement has occurred in automobile sales but there is only an uncertain and hesitant recovery in this field. More pessimistically, there has developed a significant decline in real capital spending. Burdened by heavy unused capacity, many major companies have become reluctant to increase spending on new plant and equipment until the rate of utilization of existing capacity improves considerably. In addition, there are of course great uncertainties about future energy costs which translate into effects upon future automobile sales and, perhaps more importantly, upon the entire price level as cost increases could again ramify throughout the U.S. price structure. Finally, our international relationships--interest rates, trade, and exchange rates--constitute a major area of uncertainty in relation to domestic output, consumer demand, and capital flows. These uncertainties create a considerable atmosphere of caution toward the immediate future.

With these strengths and weaknesses and the uncertain balance between them, it is indeed hazardous to say that the American economy is in a recovery phase of the business cycle. The economy appears to be past the threat of a further significant decline, at least for the foreseeable future. But to say that recovery is under way, may mean recovery only in the aggregate sense that gross national product is likely to show some improvement in real product for this coming quarter and probably a fairly sizable nominal increase. However, for many of the unemployed and small businessmen, recovery may be quite slow. Nevertheless, in assessing the impact of potential monetary policy changes on domestic and international financial relationships, one must look ahead and prepare for the next turn of events. And it is not too early to consider the degree to which the support for recovery may be compromised by the posture of our financial institutions, the position of financial markets, and the state of international financial relations. It is on these major elements that I wish to speak today.

As we near the recovery phase of this business cycle, it is important to review the position of our financial institutions because on their shoulders lie the heavy responsibility of financing the recovery. The financial institutions of the United States went through a severe period of pressure and illiquidity during most of 1974. But since late in that year, and with accelerating emphasis into 1975, most financial institutions have been able to increase liquidity markedly by the inflow of time and savings deposits and by repaying debt both to the Federal Reserve and to owners of large denomination certificates or other borrowed funds. Liquidity of most financial institutions, especially the major billion dollar banks, has shown a remarkable improvement thus far in 1975. Large denomination certificates of deposit have been issued less frequently as business loan demand weakened. However, part of the reaction of financial institutions to problems of 1974 has been to tighten their terms of lending and thus the downturn in loans is not strictly a result of the easing conditions of business and the liquidation of inventories.

Many financial institutions still need heavy capital injections. Some capital improvement is being achieved by a very favorable earnings posture in the first half of 1975 and some by direct debt issues. There are even a few equity issues being brought to market these days. But so far, the banking industry has not reached that improvement in capital which would supply the base for a further major advance in assets. To some extent, the banking industry's position has been clouded by the uncertainties centering on the disclosures necessary to come to market, such disclosures being required by the Securities and Exchange Commission. But these uncertainties may be largely cleared away with the basic agreements of the three Federal banking supervisory agencies and the Securities and Exchange Commission. Thus it is reasonable to expect that major banks and bank holding companies too will soon be in a position, both of disclosure and market relationships, to achieve meaningful additions to their capital bases.

To analyze the condition of banks for recovery support, it is necessary to consider the prospects for lending. In one major area there is not likely to be much near-term improvement. The overhang of real estate investment trust loans which are on a non-accrual basis constitutes a major workout package for a number of banks. Consequently, these banks and others, because of the publicity relating to that industry, are providing very little credit for land development, new condominiums, or multi-family apartments.

But for the most part, the bankers of the nation, with the lessons of 1974 fresh in mind, may be expected to be somewhat slow in granting formal credit commitments and slower still in accelerating their use of borrowed funds especially in the issuance of long-term certificates of deposit. One would expect the bankers to seek a better balance in their loan portfolios with less concentration, a wariness of consortium lending, and a closer relationship between their deposit and lending activity abroad. But over-all, the nation's banking industry appears to be nearing the point at which it could absorb another reasonably strong loan demand, especially if it were to come at a steady, rather than precipitous, pace.

A second major element in our financial review today must be the position of the financial markets. The capital markets have absorbed large corporate and Government issues during the first half of 1975, and prospects are for continued heavy demand in the second half of the year. The Treasury is a major borrower, supported, however, by the very large savings on the part of individuals and thus heavy buying of Treasury issues by banks and thrift institutions. At the same time corporations have sought long-term funds, to repay their bank loans, to achieve some additional restructuring of debt, and to provide funds for capital spending.

Interest rates in these long-term markets are relatively high for the start of a recovery period. But as has been said, repeatedly, these rates contain an inflation premium which is not likely to be eroded until the market and investors are convinced that the rate of inflation is going to continue to decline. Many analysts, however, are rather nervous about starting a new recovery phase with long-term market rates in the 8 to 9 per cent range, for they view a new recovery period as one which is likely to bring pressures for higher rates as business increases its bank credit demands and the banks become less willing purchasers of Treasury securities. In such an event the Treasury would indeed be competing heavily for the available funds in the market and some would-be borrowers eventually could be priced out of the market by a higher level of interest rates.

One needs to recognize, moreover, that long-term capital demands for housing and the construction industry have been quite weak, and only in very recent months has any significant improvement been shown in this field. If, as in past periods of economic recovery, the housing industry begins a marked expansion, it will require a sizable amount of new credit to meet the growing needs of the construction industry. Similarly, when the capital goods industry begins to revive and businessmen see an improvement in their utilization ratios for current capacity and begin to plan for enlarged new capacity, business demands in the capital markets will accelerate.

Bank loan demand thus far in 1975 has been quite weak, principally because businesses have been repaying their bank loans both by pay down from inventory liquidation and by issuing longer-term debt. Consumer loans also have been quite weak as consumer demand for heavy durables, particularly automobiles, has been sharply lower than in previous years. In addition, land development and multi-family construction loans have been slow in view of the overhang of unsold properties. Security loans, reflecting the gains in the stock market, have shown some increase in the first half of 1975.

When recovery really develops, however, as business inventories reach bottom and consumer demand continues to exert a drain on inventories, business activity will increase. With this increase will come rising costs of production and inventory rebuilding which will require lending assistance from banks. If the second half of the year shows a modest recovery rate, business loan demand should be equally modest and pressure on credit accomodation may not develop until late in the year or even into 1976. But consumer loan demand may also improve as the rise in housing units and payroll increases bring further advances in consumption expenditures for durable goods and with those a need for bank credit financing. Similarly, security loans could increase if the advance in stock prices continues. The generally increased cost of doing business in virtually all lines--farming, business, real estate, and construction--will require more credit for 1976 production. Short-term interest rates are likely to increase as recovery advances--threatening another round of disintermediation. However, if the change in rates is slow, recovery is reasonably balanced, and inflation subsides further, there could be an equilibrium of rates reestablished without undue pressures.

The third sector of finance important to the recovery is the international market area. During the first half of 1975, there were rather large moves of capital across borders with OPEC surpluses flowing both to investment and deposit areas. At the same time, banks in the United States were accommodating more and more foreign borrowers in view of the weak demand for loans in the United States. More recently, increases in short-term interest rates in the United States may have attracted some capital flows to this country and these could form the basic for still further bank participation abroad. The nation's balance of trade has been quite favorable in the first half of 1975 but prospects for the second half may be less favorable, especially if recovery strengthens and consumer demand spreads into the import area.

The position of the international markets is also reflected in the dollar exchange rate, showing first a decline in the dollar rate through April and then a sharp reversal, bringing the total change to a heavy plus for the dollar thus far in 1975. The competitiveness of U.S. exports was greatly enhanced by the erosion of the dollar's exchange rate in the early part of 1975 but this competitiveness on a price basis may have weakened somewhat in the past few months. Many foreign observers still believe that the United States dollar is undervalued in relation to other major currencies.

One positive result of the trauma of late 1974 and the early part of 1975 is that at least a number of foreign observers have become convinced that the dollar will remain the principal vehicle and reserve currency of the world. Despite the problems of floating exchange rates, countries still maintain heavy reserves in dollars and use those dollars for transaction purposes. This burden on the U.S. dollar, interfering as it may in the policies the United States might have normally adopted, still has some benefit to this country in its ability to market debt and to strengthen the international standing of its currency. As recovery improves in the United States, unless a parallel move develops throughout Europe and the other major industrial nations, there will be even greater attraction toward U.S. markets. As interest rates move upward attracting funds into the United States, there is likely to be an even further deepening and broadening of the capital markets of this nation. European and Far Eastern countries may be somewhat impatient with the rate at which the United States is leading the world out of the recession. Nevertheless, the U.S. is coming out in a much better balanced position with its rate of inflation falling rapidly and with a base for recovery which looks as if equilibrium could be reestablished unless there are major and significant external forces or crop failures which disrupt our current efforts. Perhaps our major worry for the months ahead is still the energy cost and the impact which a further advance in energy prices would have.

Of the three major sectors, the banking, credit markets, and international markets, it seems to me that the one in weakest position to handle the recovery is the international market. I believe this is so, partly because of the exchange rate fluctuations and uncertainties within that market. Another factor is the lack of any stabilizing force which would keep significant speculative forces from moving sizable amounts of funds across national borders and impacting upon both rate levels and competitive positions of exports and imports. Moreover, the significant problem of the less-developed countries and their costs of financing imported energy may be a continuing destabilizing factor in the international area for years to come and it may be particularly difficult in the interim recovery period. While U.S. banks and financial institutions can play a role in smoothing the flow of OPEC surpluses into credits for less-developed countries, the entire job cannot be done in private circles. International agreements among nations will need to be developed to an even greater degree if this financing problem is not to weaken the entire financial structure to a greater extent. In summary, while the U.S. is poised for the beginning of a recovery period in its domestic environment, one of its principal worries must be the impact of those recovery policies upon the international financial markets and the development of cooperative and participatory trade, investment, and transfer policies with other nations of the world.

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