A TIME FOR CONFIDENCE

An Address Before the
Georgia Electric Membership Corporation
Marriott Motor Hotel
Atlanta, Georgia
December 2, 1974

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When my friend Walter Harrison offered me the privilege of speaking to you some weeks ago, he urged me to discuss my confidence in our banks and in the American Banking System. This is a time for confidence. I want to tell you why I think that confidence is well-founded.

Many people are asking questions about banks these days. Our banker friends tell us of customers calling to ask the details of FDIC insurance, or to ask whether they can get in their safe deposit boxes if the bank closes. These are questions no one would have thought to ask a year ago, or five years ago. The fact that they are being asked now reflects, I think, a general deterioration during the past year of the public's confidence in banks in general and in their own bank in particular. These questions have been fueled, to be sure, by several well-publicized cases where banks got into difficulties. Even in cases like these, however, not a single depositor has lost a nickel and there is no prospect that they will.

I have to think, rather, that this public concern about the banks reflects a deeper general concern about the economy. The fear seems to be that the

*Prepared for Mr. Kimbrel's use by William N. Cox, Assistant Vice President and Chief Financial Economist.
business and governmental leaders of our nation have either failed to recognize the severity of the situation or are somehow unable to come to grips with it. It seems to be not so much a fear of what will happen, but instead an uncertainty about what the prospects are for the economy and the financial situation—a feeling that no one knows what's going to happen and that no one will be able to deal with it when it does. With the economy as well as with the banks, it is indeed a time for confidence. There is, accordingly, no way for me to talk to you about my reasons for confidence in the banking system without first talking about the more basic economic situation.

As I reviewed the situation to prepare for coming here today, it occurred to me that inadvertently I have been conducting an audience interest survey: Friends, associates, and other persons with whom I come in contact repeatedly ask me certain questions—the same questions.

Immediately when someone learns that I am associated with the Federal Reserve System, they feel impelled to ask me, first, "Why are you always talking about inflation?" I must admit I generally am. Public remarks I make almost inevitably dwell upon our inflationary problems. As I shall discuss later, I believe that I have good reasons for doing so.

But, if people do not ask me about why I am concerned about inflation, they will almost always ask me, second, "When are we going to get some relief from high interest rates?" Many of you, I expect, would be among that number. For example, the other day I made an appointment with my doctor and was anticipating cataloging my major and minor aches and pains in answer to his expected, "How do you feel today?" But instead of asking me how I was feeling, he started with, "Why are interest rates so high?" and went on from there. I felt I should be charging him a fee by the time the appointment was over.
Before I left I explained in the clearest language possible the reasons for present high interest rates. He then asked me, "When will rates go down?"

Lately a third question has become relevant. It is one in which the individual usually starts by saying, "Isn't it true that...?" The questioner will say "Okay, we have had severe inflation, but now isn't it true that we have an economic recession, too? Why do we have both?" Why, he asks, should we have faith in the economy?

To summarize, these are the questions I would like to discuss in moving toward an answer to Walter Harrison's question about confidence in the banking system:

1. Why are you always talking about inflation?
2. Why don't you give us some relief from high interest rates?
3. Why do we have both inflation and an economic recession?

Let me touch on each of these in turn.

Ten years ago, inflation was not a problem. The dollar was retaining its purchasing power. But beginning in about 1965, price behavior changed from stability to steady increases, and these increases have mounted to double-digit levels in 1974. Wholesale prices, for example, are on an 11-to 12-percent track in 1974. In the past two years alone, every dollar has lost 18 cents of its purchasing power. As a result, the real spendable earnings of the average American family have actually fallen about 4 percent during the past two years, an event unprecedented since the Great Depression. The price increases we encounter every day, for things like gasoline and groceries and, yes, utility bills, have been even greater than the increases reported in the economists' price indices: The inflation has been severe, it has been widespread, and it has been visible to all of us.
To my mind, moreover, the inflationary corrosion of the monthly paycheck has had a strong psychological effect on all of us. Ever since the Korean War, American families have experienced an increase in the purchasing power of their paychecks. Year after year after year, most of us have shared in this increase. Most of us have felt justified in believing, and in acting as if, these increases would persist indefinitely, to provide growing incomes to pay down our debts and increase our standard of living without interruption. I remain confident, incidentally, that over the long pull this will indeed be the pattern of the American economy.

But here in 1973 and 1974, we have had an interruption in that pattern. Families who a couple of years ago were looking forward to a second car, or a second home, or a bigger and better vacation every year, who were willing to borrow against future paychecks to get them, and businesses who were looking ahead to new product development and acquisitions for balance-sheet building, suddenly found themselves having difficulty just paying the grocery bills or coming up with enough working capital to continue operations. The psychology has changed. Two years ago we were willing to bank on the future; now our families and our businesses have pulled in their horns, cut back their spending, and are trying to build up reserves in preparation for an uncertain future. Business spending plans, consumer sentiment, the lack of customers on the auto showroom floor—all of these give testimony to the change in psychology, lack of confidence we now seem to have that our real standard of living will continue to improve. And this has come largely because of the erosive effects of inflation. This is a time for confidence.

Now the mandated function of the Federal Reserve System is "to foster a flow of credit and money that will facilitate orderly economic growth, a
stable dollar, and a long-run balance in our international payments." Price increases in the past four years, therefore, cannot help but be of primary concern to me, as an official of the Federal Reserve System. Such price rises over the long run also are not only harmful in themselves but history has shown that inflation prevents orderly economic growth and achieving a balance in our international payments.

Despite the claims of both our friends and critics, the Federal Reserve System does not pretend that its policies are the sole or even the principal force influencing the direction of the economy. Its powers are largely limited to influencing the availability of credit through its control over the amount of reserves it makes available to the banking system. Nevertheless, the Federal Reserve System has an obligation to use whatever powers we have to produce greater price stability.

"What does all this have to do with high interest rates," you may well ask. Furthermore, you ask, "Why don't you give me some relief from high interest rates?" Your business, especially, feels the pressure of these high rates.

Rising prices, as you well know, are a normal symptom that purchasers' appetites are too great to be satisfied by the nation's producers at constant prices. It is elementary that a further increase in this appetite will push prices up further. Now interest rates, too, are prices, determined by the amount available and the appetite for it—what economists call the supply of and demand for credit. The Federal Reserve System's influence on interest rates comes from its ability to change the availability of the reserves held by our member banks. If we curtail the reserves available to the banks, they
find it more difficult to supply credit to individuals, businesses, and governments.

The interesting thing about the high interest rates we have had in 1974, however, is that the Federal Reserve has not---has not---shut down the supply of reserves to the banking system. We did that in 1966 and in 1969, and the high interest rates then could properly be attributed to the Fed's policy of restraint. This time, however, the Fed continued to supply reserves to the banks, not just at a normal rate, but at a greater-than-normal rate. The statistics are there to prove it.

But credit has been scarce, you say, in 1974. Expensive, yes; scarce, no. Let me share some figures that may surprise you. As best we can measure it, the amount of credit which has been extended in our economy thus far in 1974 is running only marginally below what it ran during a comparable period a year ago. The Federal government, including not just the Treasury, but also government-associated borrowers like the Federal Financing Bank, has borrowed about the same amount it did a year ago. State and municipal governments have also kept pace with last year's borrowing, despite some special situations where interest rate ceilings have kept some municipalities out of the market.

Businesses have not just kept pace; they have borrowed more than they did a year ago. They have borrowed somewhat more from the banks, but it is in business trips to the capital markets that the increase shows up dramatically. Despite the inability to raise funds in the equity market, despite the record rate levels in the corporate bond market, despite the talk of credit scarcity, despite the pressure on bond ratings, American corporations
through October of this year borrowed $10 billion more than they did in the like period a year ago. Ten billion dollars more. Credit has not been cheap, but it has been available.

With total credit flows about the same in 1974, and with business borrowing on the increase, the increase had to come from somewhere. We all have a pretty good idea where it came from: It came from mortgages and from consumer borrowing, where the borrowers were unable or unwilling to compete with businesses, with the Federal government, and with the municipalities for funds.

Interest rates have not been so high, then, because of any drastic cutback in the amount of funds available to borrow. Rather, interest rates have soared because a normally-adequate amount of credit has not been sufficient to meet the enormous appetite for borrowing. It is in this sense, and in this sense only, that credit has been scarce in 1974. Why has the appetite for credit grown so voraciously? Largely because of inflation. You can look to your own experience to tell you that higher material costs and higher wages mean a greater need for working capital. You know, too, that if you expect a power-generating facility to cost 10 percent more to build next year than right now, that it is smart business to borrow the money now at 9 percent and go ahead and build the facility. Our families use the same reasoning when they borrow to buy a 1974 model automobile to beat the price increases they expect on the 1975 models.

Paradoxically, then, the high interest rates we have seen in 1974 have been both designed to fight inflation and have also been a result of that same inflation. Under the mandated responsibilities I mentioned a moment
ago, we at the Federal Reserve have faced a choice between supplying enough bank reserves to sate the appetite for credit temporarily, thereby adding further fuel to that same inflationary appetite a year or two from now, or alternatively, permitting a normal expansion of credit in the knowledge that inflationary appetite will not be satisfied. Obviously, we have chosen the latter course, if indeed there were ever any choice at all. So the answer to the question of "When are you going to give us some relief from those high interest rates?" is simply "When the appetite for credit drops off enough to permit the rates to fall."

Returning to my theme of confidence, we see some signs already that this is beginning to happen. Although it will probably take several years for us to return to the price stability of the early 1960's, we do seem to have reached the high-water mark in price increases. Even while the headlines have talked about special situations such as sugar prices, we are seeing a tapering off, and even in some cases a price break, in some of the sensitive industrial commodities. Here and there, with increasing frequency throughout the economy, we see mention of price reductions. I have confidence that we are beginning to work our way out of the inflationary spiral, and that the accompanying appetite for credit is also beginning to recede. The recent break in short-term interest rates reflects this gradual decreasing appetite more than anything else. It is a time for confidence that we are winning the battle against inflation.

So much for inflation, and for the high interest rates inflation has brought in its wake. But now we not only have inflation, we have a recession
too. Unemployment is high and headed up; the papers carry headlines of layoffs and production cutbacks. Why?

To some extent, this is the expected result of the anti-inflationary efforts of the Federal government and of the Federal Reserve's decision not to supply credit at a greater-than-normal rate. But only in part. Our sluggish economy is also feeling the effects of some rude shocks in recent years: The churning and displacement are manifestations of our economy's efforts to adjust to those shocks, much as a person runs a fever while his body fights an infection.

Some of the shocks are probably temporary, such as the world-wide shortfall in grain production and the apparent shortfall in sugar production. Time, bringing increased production, should take care of these. But several of the shocks, notably the two dollar devaluations and the increase in oil prices, are apparently permanent, thereby necessitating permanent readjustments throughout our economy. This is proving to be a painful process. In your business, you are strategically placed to see these readjustments, many of which are appearing in the state of Georgia. This process of adjustment we are going through provides a significant part of the reason we have both recession and inflation. It also provides grounds for confidence that our economy can work its way through the adjustments successfully.

Some columnists and commentators these days are expressing the wistful hope that we could return to the pre-devaluation days of 1971 and, in a sense, start over. Part of the resurgent interest in wage and price controls is probably based on this kind of hope. The point these commentators miss, however, is that even if we could somehow turn the clock back and re-establish
prices and wages at their mid-1971 levels the situation would still be quite different from what it was then. The devaluations and the oil price increase had an impact on the American economy approximately equivalent to a 5-percent cut in our standard of living. Devaluation means that the family which buys a Japanese automobile or the business which buys a German machine tool must now pay more for these products. Even if our prices in this country reverted to 1971 levels, the family would have to pay more for his imported automobile out of his 1971 income, leaving less to spend for other things. This is the sense in which the devaluations effectively reduced our standard of living. In the case of the oil price increase, you can see the implications much more directly. If the refiners were forced under some system of controls to sell fuel oil to you at the old prices, they would face three choices. They could go out of business because their costs of crude oil exceeded what you could pay them for it, or they could sell the fuel oil outside the United States, or they could try to find ways to evade the controls. If the controls applied to you but not to them, you would be in much the same situation: There would not be a "fuel adjustment clause" and you would be in an impossible situation. Commentators and columnists to the contrary, there is no way to get back to where we were. The increased cost from devaluation and the fuel price increase must be borne by someone.

Our economy is now adjusting to the new situation, in ways that are well-illustrated by events in the state of Georgia. It all fits into a pattern. Let me give you some specific examples:

--higher gasoline prices have cut into the transit tourist traffic running through our state, cutting into the business of motels, restaurants, and the gasoline retailers themselves.
— higher prices for crude oil have been passed into higher prices for synthetic textile feed stocks, raising the cost in a significant proportion of our state's most important manufacturing industry, at a time when the consumers are resisting those higher prices.

— higher prices for the fuel needed to run tractors and farm machinery, and to dry tobacco, have raised the cost of crop production, not to speak of the fuel-related price increases in phosphate fertilizer.

— in your own cases, you see close at hand the increasing costs of electric power generation.

Adjustments like these in our own state are, moreover, only the first stage. We are also going through what might be called a secondary reaction to these price increases in turn. Businesses are trying to figure out ways to cut back their usage of electric power, now that it has become more expensive. Families' purchases of small electrical appliances have dropped off remarkably, thereby prompting adjustments on the part of the manufacturers who produce those appliances. And just to articulate this one example a step further, the movement from vacuum tubes to transistors in television sets has been accelerated by the fact that transistors use less electricity. This has in turn put pressure on the producers of these transistor devices.

A smaller sequence has occurred in cotton as a substitute for petroleum-related synthetic fibers, in the demand for small cars, in coal as an energy substitute for oil. We can all agree, I think, that the current coal strike would not have been possible two years ago without the new dependence our nation is attaching to coal.
These uncomprehensive examples illustrate the permeation of adjustments in our state just to the oil price increase; reactions to the two dollar devaluations are, if anything, more complicated and more difficult to trace. We see these adjustments popping out in a bewildering array of industries, which has heightened the public feeling that no one seems to know what's going to happen next, and has lent support to those who say "Let's stop this adjustment process with price and wage controls." As you can see, my own feeling is that to do that would only prolong the day when we will have readjusted and are moving forward again. The painful unemployment and the dislocation we experience now are indicative of the fact that the economy is adjusting and adapting to its new set of circumstances. We can try to ease the transition with public service employment, with programs to help shift our nation's productive resources from where they are extra to where they are needed. It is incumbent on us at the Federal Reserve, moreover, to keep enough credit flowing to facilitate this transition. But the last thing we should do, again, is to impose price and wage controls as an impediment to the transition.

Despite the twin burdens of inflation and recession, then, I see a silver lining. It is a time for confidence. The unemployment and the dislocations, the bursts of price increase here and there, suggest to me that our economy is functioning well as it adapts to the shocks which have been imposed upon it. I would be worried, in fact, if we did not see these dislocations, for that would indicate a lack of responsiveness in our nation's markets. It is a time for confidence. If we stick with it, resist the
temptation of quickie solutions like price controls, and do what we can to ease the pain of transition in the hardest-hit cases, with luck we should come out of this situation just as we did in the early 1960's; we are working toward full employment and price stability on down the road.

In this environment of transition, what, then, of the banking system? Is it a time for confidence there, too? Unquestionably, I think. As you are all well aware, the danger of deposit losses and bank closings of the sort we experienced 45 years ago is so remote as to be nonexistent. Depositor insurance, recently extended to $40,000, is the final line of defense, and it is a sufficient one. But it is instructive and reassuring to note that in rare cases like Franklin National and like American National over in Orangeburg, South Carolina, depositors have not lost a nickel. We at the Federal Reserve share a responsibility with the other banking agencies to ensure that the public's confidence in its banks is not misplaced. This is a responsibility we have not shirked and we do not intend to.

Beyond the question of bank failures, however, you may realize that our larger banks are now going through a transition, just as is the economy. Part of this transition in banking involves a reassessment of the liability-management or "go-go" banking which attained passing favor during the past ten years. Essentially, this involved a relatively unrestrained writing of loan commitments to businesses based on a faith that, when the borrower came in to take out his loan, the bank could go out and borrow the funds to relend.

You can see the difficulties with this practice if we compare it to a situation in your business. It is as if you contracted to supply power for several years at a fixed price to large industrial users in your service...
area, counting on being able to buy wholesale supplies of power at the going rate on a week-to-week or month-to-month basis. When your costs go up, as the banks' costs of funds did, profits are squeezed. Furthermore, if all the electric cooperatives decided to do this without making prior arrangements for the power supplies, the result, I suppose, would be something like a "brown-out." There might not be enough Kilowatt-hours to go around. This is the kind of difficulty many of our larger banks worked their way through, and out of, this year. Go-go banking is giving way to more prudent practices in making and meeting loan commitments, and the banking system is emerging from its transition stronger and healthier than it was two or three years ago.

There are other exciting new developments in banking. One of them I especially want to mention is the transfer of payments electronically, and is happening right here in Georgia. Over 400 banks in the state have joined us in an automated clearing house designed to speed up the transfer of funds and eliminate some of the paperwork associated with them. Another is the increased participation of banks in service activities outside the traditional banking sphere; some of you are probably using data processing or billing services provided by your bank, I expect. I cite these two developments to exemplify the growth and vigor of our banking system and to underscore my earlier answer to Walter Harrison's question: "Yes this is a time for confidence in the banks."

Looking back over what I have told you today, I realize that the confidence about the future I urge upon you is not shared by some. Nevertheless,
I think the reasons for my confidence are ample, as I have explained these past few minutes. It is a time for confidence—confidence that we are making headway against inflation, confidence that our economy can cope with the adjustments it faces, and confidence that our banks will remain solid, secure and serviceable through the transition.

I thank you for letting me share this confidence with you today.