THE ECONOMY AND THE BANKS

REMARKS BY

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Regional Conference
National Bank Examiners

San Diego, California
April 22, 1976

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Whenever people from the regulatory agencies get together these days, they're liable to discuss nothing else but the status of the latest legislative proposals from Washington. I can probably add very little to what has already been said on the subject; in fact, my advice would probably go along the lines of—"First, you get all the wagons in the circle and . . ." Consequently, I believe I can use my alloted time on today's program more usefully by reviewing the financial environment in which you'll be doing your work this year. There's no question that 1976 is turning out to be quite different from those several difficult years that preceded it, and this difference is bound to have a strong effect on the balance sheets that you'll be examining in coming months.

Before getting into that subject, however, I'd like to mention briefly two substantial achievements of the banking system—one in 1974, and one in 1975—that tend to get overlooked in current discussions of the banking scene. First, in 1974, the banking system played an essential role in stabilizing the economy at a critical time, at some cost to itself. At mid-1974, bank funds in many cases were the only funds available to small-and medium-sized firms, as money and capital markets tightened drastically in the face of double-digit inflation. Moreover, public utilities had nowhere else to turn for funds, since they were unable to obtain needed funding through internal sources or through the capital market. The resultant heavy loan demand strained the liquidity of many banks—but it helped to support the economy at the time it was most needed.

The big achievement of 1975 was the banking system's ability to start regaining its own strength, even while contributing to the growing health of the national economy. Those banks that had participated in the go-go atmosphere of the late '60s and early '70s learned their lesson, and by 1975 they were carefully appraising all risks and striving for an adequate return on assets. For example, large commercial banks increased their liquid-asset holdings 33 percent in 1975, while sharply reducing their reliance on volatile sources of funds. Meanwhile, banks improved their profits in the face of increased loan-loss provisions and shrinking loan portfolios. The fifty largest bank holding companies, for example, reported a 7½-percent increase in net income for the year—and they would have reported a 42-percent gain if they'd used the same loan-loss provisions as they did the preceding year. Further, they used their improved earnings to help build up their capital positions, and thereby ended the prolonged decline in capital-asset ratios that had been so painfully apparent to regulators in the earlier part of the decade. California banks, for example, raised their ratio of total capital and reserves to total assets from 4.90 in 1974 to 5.04 in 1975.

Strengthening Economy

Against this background, let's consider the economic situation at this stage of the recovery path. In striking contrast to the picture a year or two ago, everything seems to be moving in the right direction so far this year. In the consensus view, total production (in real terms) should rise about 6½ percent in 1976 after a decline last year; the jobless rate should drop from 8½ percent to about 7 percent; and the inflation rate should drop from 9 percent to roughly 6 percent. The unemployment and inflation projections suggest that we're still not completely out of the woods, but those figures should be viewed in the perspective of what went before—and in the perspective of the current strength of the employment, income and production statistics.

Consumer buying, which generated the upturn a year ago, should continue to provide strong support to the recovery as this year progresses. Experience teaches us that, whenever households become more confident about job stability and price stability, they reduce their savings and accelerate their spending. The economy has benefited from just such an upturn in consumer psychology over the past year, and also from the improvement in consumers' financial positions brought about by rising payrolls and rising stockmarket prices.

Consumer spending for new housing should also be a plus, on the basis of a slow improvement in underlying demand factors and a massive buildup of funds in mortgage-financing institutions. Business spending for new plant and equipment may turn out to be much stronger than expected, as businessmen begin to realize the amount of new capacity that will be needed to serve the markets of the 1980's. Finally, business firms may be forced to expand their inventory spending substantially to meet the growing markets of 1976, since they swept the shelves clean last year in the biggest inventory cutback of the last generation.

Supportive Policy

The 1976 assignment for fiscal and monetary policymakers is to develop policies consistent with a moderate and sustained recovery—but not to generate a boom that would bring about renewed instability in prices, income and employment. I must confess to a nagging fear in this regard, since the underlying cause of the terrible inflation of the past decade has been the tendency of Federal deficits to expand in good times as well as bad, pulling monetary policy off course in the process. Huge deficit financing apparently was necessary last year to offset the effects of the worst recession of the past generation, but substantial deficits have troubled us not for just a year but for an entire decade. Indeed, only one surplus year was recorded in that entire period, as the Federal government and its agencies went into debt to the tune of $300 billion.

The deficit is estimated at $74 billion for the current fiscal year alone. On top of that, the two Congressional budget committees are now talking in terms of a $50-billion deficit for fiscal 1977, despite the lack of need for further stimulus for a strengthening economy. The danger is that overly expansionary policies could rekindle inflationary expectations among consumers and producers—understandably enough, in light of recent history—and that these inflationary expectations could distort purchasing decisions and undermine the long-run growth and stability of the national economy.

This is an important consideration for monetary policymakers to keep in mind. Our basic objective, of course, is to support a substantial rate of growth in output and employment, while avoiding excesses that would aggravate inflation and create future problems for the economy. In following this objective, we have attained a growth in the money supply within the target ranges announced about a year ago. Over that period, M_1 has increased about 5 percent—M_1 being currency plus bank demand deposits—and M_2 has increased more than 9 percent—M_2 being M_1 plus bank time deposits except large CD's.

We've heard criticism from many quarters that the money supply has not grown fast enough, given the amount of slack still left in the economy. However, the growth we've experienced obviously has been adequate to finance a vigorous recovery, a drop in the unemployment rate, and a slowing in the inflation rate—not to mention a decline in interest rates. Indeed, this past year's experience has been roughly in line with the average money-growth rate of the preceding five-year period—and yet throughout most of that earlier period, the Fed was criticized not for going too slowly but rather for stoking the fires of inflation with an over-rapid growth of the money supply. This suggests that as the economy continues to strengthen, we'll have to reduce the rate of monetary and credit expansion, in order to lay the foundation for a prolonged era of prosperity without inflation.

Consequences of Past Actions

Now, the nation's financial markets obviously have benefited from the upturn in the economy and the supportive stance of fiscal and monetary policy. Still, there are many lingering problems, as you may know perhaps better than most other observers of the financial scene. This thought struck me recently, as I re-read references in some of my old speeches to the major problem situations of 1975. Here's the catalog as I saw it last fall: W.T. Grant down to its last five-and-dime; the airlines fast losing altitude; the tanker business on the rocks; the jerry-built REIT's crashing to the ground; New York desperately trying to sell Brooklyn Bridge, and so on. We don't have Grant's left to kick around anymore, but some of those other problems may yet take years to resolve, and there are no guarantees that 1976 will not produce a few more casualties in addition to some charge-offs of existing problem loans.

Let's consider the situation here in California, as shown by the examination reports—yours and ours—over the past several years. Loan losses of California member banks increased from 0.28 percent of total loans in 1973 to 0.36 percent of the total in 1975, while the percentage of doubtful loans rose from 1.04 to 1.80 percent and the percentage of substandard loans rose from 3.17 to 6.09 percent. Loans not included in those classification figures, but still listed for special mention as requiring more than usual management attention, jumped from 1.09 to 5.13 percent of total loans between 1973 and 1975. Thus, over a two-year period, the proportion of criticized loans rose from 5.58

to 13.38 percent of the total.

Those figures seem to prove the long-held theory that a prolonged business expansion always brings some lowering of credit standards in its wake. In other words, bad loans are made in good times and good loans are made in bad times. During the early 1970's, too many bankers believed that they could assume greater lending risks and rely on an expanding economy to bail out the marginal credits. With their philosophy of growth for growth's sake, too many of them made loans simply to obtain business and/or meet competition, and failed to pay enough attention to such basics as loan documentation and repayment programs.

Liquidity and Interest Rates
The banking scene in 1976 cannot help but be influenced by the prolonged and sometimes painful working-out of these problem situations. The crucial point to remember, however, is that credit has become more available and less costly in the recovery period of the past year, considerably easing the problems of the banks and other market participants. The liquidity position of financial institutions and business firms has improved greatly. For more than a year, corporations have issued a record volume of long-term bonds, using the proceeds to repay short-term debts and acquire liquid assets. Commercial banks have reduced their reliance on volatile funds and added a large quantity of Federal securities to their portfolios, and thrift institutions similarly have strengthened their liquidity positions. Meanwhile, the good times on Wall Street have helped restore financial health to individuals and have made it easier for corporations to raise equity funds for investment or liquidity purposes.

The interest-rate situation has been quite favorable in recent months. Short-term interest rates normally begin rising at the very outset of a business expansion, and that trend should have been reinforced in the present case by the continued high rate of inflation and the record volume of Treasury borrowing. But except for last summer's runup in rates, the trend did not develop as expected. Instead, short rates generally have moved downward since last fall, to the lowest levels of the past three years. Meanwhile, long-term rates have moved in the same direction, with yields on new Aaa corporate issues lower than at any time in the past two years.

With most interest rates now lower than they were at the trough of the recession, a good case can be made for a rise in rates as the economy continues to expand. Short-term interest rates are influenced by such factors as business conditions, inflation expectations, and monetary policy, so that even without a change in the other factors, a strengthening in borrowing demands resulting from the business expansion should create upward pressures on rates. However, the mix of forces is rather different for long-term rates. Since inflation expectations play such an important role in this end of the market, a continued easing of price pressures could cause lenders to lower the premium they demand for expected future inflation and thereby create downward pressure on rates. Thus the different types of pressures operating in different segments of the market could lead to a somewhat unusual divergence in rate movements as the year goes on.

All of these economic and financial considerations suggest that the banks' situation—and yours—should be less exciting but somewhat more rewarding over the next year or so. Almost before our eyes, the rising tide of business recovery is lifting all the boats, including some leaky ones called problem loans. Behind every problem loan is a problem corporation, which is able to work out its difficulties much better in a rising than in a falling market.

The improved business environment thus should permit banks to work with borrowers to prevent most loan defaults. Many loans which are now on a reduced-interest basis or even on a non-accrual basis should again become full interest-accruing loans. Of course, unexpected occurrences such as prolonged major strikes could result in a rash of problem loans for firms which are not prepared to ride out such events. Yet with loan-loss reserves now built up to record levels, banks generally are in much better shape than they were a year ago to handle such contingencies.

Business Loans and Mortgages

Let's consider the situation today in some of the asset categories where problems had occurred earlier, beginning with business loans. Despite the expectation of rising business sales and hence of inventory restocking, several factors suggest that the increase in short-term bank borrowing for inventory purposes may come somewhat later, and be less sizeable, than we would expect judging from the pattern of previous business recoveries. These factors—increased corporate profits, higher cash flow and increased liquidity—all stem from the overall improvement of corporate finances. Continued heavy corporate borrowing in the capital market also could result in a smaller-than-expected level of borrowing from the banks. Still, these remarks apply primarily to the larger and more creditworthy business firms, which have the incentive to go directly to the market to take advantage of the unprecendented spread between the banks' prime rate and market interest rates—and which have much more ability to do so than less well-known firms, who have to rely primarily on local banks for financing. As inventory-financing needs increase, borrowing demands could be heavy from businesses with lower levels of profitability and liquidity and higher incidence of risk. This situation will force banks to screen credits carefully and establish viable loan-commitment limits for such borrowers.

The real-estate financing picture could remain troublesome, in view of the continued problems with past REIT financing. There may be added defaults, while most of those loans now on a reduced-interest or non-accrual basis may require extended work-out periods. The problem is compounded by the still-weak demand for multifamily housing, with condominiums and other units still standing empty in many sections of the country. Meanwhile, the single-family housing sector should be relatively trouble-free, although we may question whether the large new volume of bank savings deposits provides a stable enough source of funds to back long-term mortgage loans. A large portion of the near-record inflow of passbook savings represents highly interest-rate sensitive funds. The total includes corporate savings deposits, whose volatility probably matches that of demand deposits, as well as individual savings which could easily flow back into money-market instruments if the present favorable rate differential should disappear.

Incidentally, a rather tricky problem for lenders (and examiners) could result from the growing acceptance of variable-rate mortgages. For example, the lender could be disadvantaged where the "band is asymmetrical"—that is, where there is a ceiling on rising rates but no floor (or else a wider band) for falling rates. Further uncertainty could result from the borrower's privilege to pre-pay, without penalty, within 90 days of a rate-increase announcement, or from the possible lagged effect on bank profit margins of tying the rate to a thrift-institution cost-of-money index.

Other Sectors to Watch
There should be somewhat fewer problems with consumer instalment financing than with mortgage financing. As I noted earlier, consumers are in much better financial shape than they were a year ago, and this has allowed them to take on new debt and also to improve their repayment performance. Moreover, many banks have made special efforts to weed out their poor credit-card risks. Naturally, as consumer spending accelerates, credit screening will have to be tightened, and some attention will have to be given to excessively easy terms on auto loans and other such transactions. For example, the proportion of auto loans with more than 36 months' maturity jumped from 4 to 20 percent between 1973 and 1975, and this could create potential difficulties for both borrowers and lenders.

Municipal-bond financing problems are well-known, of course. Although the market's performance has improved considerably, it is still extremely selective, and some municipalities have been forced to cancel offerings because of the fuller disclosure required prior to the marketing of new issues. Reviewing banks' municipal portfolios thus will require special vigilance. For instance, the maturity distribution of bank holdings may present difficulties in light of current marketing problems. This may mean that banks are "locked in" in certain cases even when they are willing to take capital losses.

Foreign loans may be one of the weaker elements in the 1976 bank-lending picture, at least partly because recession conditions have persisted longer overseas than in this country. Although foreign operations have remained stronger than previously forecast, this sector could become an increasing source of problem loans. The danger is greatest in some of the less-developed countries, but repayment problems could arise in some of the developed countries as well, as is suggested by the recent turmoil in foreign-exchange markets. Many medium-sized banks have sharply curtailed their overseas operations, but they could still encounter problems working out loans made earlier. Large banks also could suffer reductions in earnings simply because so much of their income—in some cases, over half—is now dependent on foreign loans. The new large-bank supplement to the Call Report should help examiners monitor charge-offs on such loans, but it may not provide much guidance on handling newly-developing problems.

The banking liability picture looks fairly promising. The modest loan demands of last year have permitted banks to adjust their liability structure, especially through reducing reliance on high-cost CD money, but also by lengthening the maturity structure of consumer and business time deposits. If bank loan demand increases at a moderate pace this year, as most analysts expect, banks should be able to add deposit liabilities in an orderly fashion, thus maintaining most of the improvement in maturity distribution that they've already achieved.

But as I've already noted, banks should not count too heavily on retaining all of the passbook savings they acquired in early '75 and again in early '76. The 1975 inflow reflected a recession-related build-up of household savings and cutbacks in consumption spending. The recent inflow, in contrast, reflected relative interest-rate trends, and thus could be reversed whenever rates on money-market instruments rise above the 5-percent ceiling rate on passbook savings. Whatever the cause, the projected strong rise in consumer spending will tend, at the least, to reduce the amount of new savings flowing into the banks.

Concluding Remarks

To sum up, I can only repeat what I said earlier, that your work in 1976 should be less exciting but somewhat more rewarding than it has been for the past several years. The economic outlook, backed by a supportive monetary and fiscal policy, remains quite favorable, with signs of strength now appearing in a number of consumer and business spending categories. The financial outlook similarly remains favorable, with interest rates below recession levels and the liquidity position of households, corporations and banks much improved over a year ago. The banks may encounter difficulties from the overhang of problem loans and from the continued weakness of business-loan demand, as we can already see from the early 1976 decline in large banks' earnings, yet many of the worst problem cases appear to be more manageable in 1976 than they were in 1974 and 1975.

Not all banks will benefit equally from the more favorable economic outlook. We could experience a repetition of the 1975 pattern, with some banks reporting record gains in both operating and net income and others of the same size and geographic location experiencing record declines. High loan losses and a large volume of non-earning assets do not lend themselves to quick turnaround situations. Indeed, many banks will be forced to continue maintaining higher ratios of reserves for possible loan losses. Earnings patterns also will reflect divergent trends in regional economies, since not all banks are in the enviable position of those in the Pacific Northwest, with their ability to benefit from the Alaska pipeline boom.

The balance sheets you examine this year will reflect the actions of public and private policymakers in bringing about the present business recovery, but also their earlier actions in generating a still-dangerous inflationary environment. In addition, those records will reflect bankers' cautious attitudes in rebuilding their balance sheets over the past year, as well as the earlier go-go attitudes which led to the distortion of their balance sheets in the first place. I'm sure that you'll keep all that past history in mind as you go about your job this year of judging the quality of assets and their relation to bank capital. But perhaps you'll also remember that, if history is any guide, loan quality generally should improve during this recovery, just as it deteriorated during the preceding recession.