RETURN TO NORMALCY? BE CAREFUL WHAT YOU WISH FOR

Ed looks back on his days in Texas, when dread "stagflation" made banking a challenge. Could we be headed there again?

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Many bankers are looking forward to a return to a more normal level of interest rates from the abnormally low levels of the last several years. There are good reasons for our recent rate patterns, but a return to a more robust level of loan demand and a yield curve that will reward savers as well as borrowers seems like a worthy goal.

However, what are the implications of higher market interest rates? And how should we understand them in the context of managing our bank's lending activities?

The good side of a return to normalcy

First of all, an overall improvement in our national economic outlook would bode well for loan demand. We could get back to doing what we are trained to do-making productive loans for the benefit of our local economies and the well-being of our customers. This would also be a great boost to improving the outlook for jobs, which is both a national economic and political objective at this point in the current economic cycle.

In addition, improving loan demand would tend to diffuse a political irritation that many politicians have expressed about banks.

After all, they argue, we accepted TARP money and then refused to lend it out. There are two sides to this story, of course, but at least the whole issue would recede in the public consciousness and make our lives a bit simpler in dealing with a significant portion of our external constituencies.

The iffy side of a return to "normalcy"

There is another side to look at this through, however. Can you imagine an environment where general levels of market rates go up with little or no improvement in fundamental loan demand? This is precisely an area of current concern of many market observers and economists relating to the size of the current federal budget deficits.

Creditor aversion to excessive debt levels of governments, businesses, and individuals is a well-demonstrated fact of economic life. It's not a political argument at all-it's an observation with ample empirical evidence from relatively recent economic history.

At some point, it is possible that the buyers of U. S. Treasury securities will demand higher interest rates to compensate them for the risks of holding these securities.

There's no practical reason to suspect that the United States is not capable of servicing its external debt. But what price will creditors demand for acquiring more Treasury securities? After all, inflation has been the inevitable historical consequence of large expansions of monetary supply. We don't have to go into remote historical periods but need only focus on the events of the last hundred or so years.

Inflation favors the issuers of debt by making repayment cheaper in terms of the buying power of the monetary unit of repayment. Governments find it hard enough to balance budgets in good times. So when economic circumstances turn "ugly," as they inevitably do from time to time, some inflation becomes a back door way to making debt repayment less painful. This is where the level of interest rates is important. If I'm being repaid in depreciating dollars, then I need a greater incentive to buy and hold debt securities right now.

The U. S. Treasury has benefited from international monetary turmoil in that the dollar is still perceived as the safest currency in the world. It's the one currency that is big enough to provide liquidity, while our economy is the strongest in the world even after the difficulties of the last two or three years. The real question for economists and fiscal and monetary authorities is whether this happy combination of circumstances-liquidity and economic strength-are durable over the long term with a concurrent stability in interest rates.

A return to the dreaded "S" word?

This isn't a theoretical concern. We confronted this very issue as an economy and as an industry in the early 1980s.

Inflation of the 1970s was finally brought under control by the draconian rate moves of a Federal Reserve Board determined to tame inflation. I was newly arrived in Midland, Texas, at the time and financed the purchase of my new house at a mortgage rate of 12%. That was exactly double the interest rate of my mortgage only ten years earlier in New Jersey.

Higher interest rates certainly increased the interest income of banks, but there was a countervailing impact of rising rates on funding sources.

Many banks managed that transition reasonably well, but the new market reality of higher borrowing rates was a lessening of loan demand. Borrowers couldn't profitably use borrowings when rates were in the low to mid-teens, as they were for several quarters in the early part of that decade.

Loan demand sagged. But more significantly, net interest income dropped precipitously. Making more loans was the simple answer to fixing this problem-except that our customers had lost their appetites for new credit.

The economists call such an environment "stagflation." This is a hybrid word combining a stagnation of economic growth and the continued impact of inflation.

Eventually, the high rates cooled the inflation and economic relationships gradually returned to normal. But a price had already been paid. Our national economy lost several quarters of real economic growth. And banks sustained several years of anemic returns on equity.

Be careful what you wish for

For the last several months, bankers have anticipated a return to better economic times. I certainly hope this happens. But it's not guaranteed anywhere that it will.

Meanwhile, there are growing concerns about a double dip recession and an increase in market rates of interest due to the huge debt appetite of our national government.

Without an increase in loan demand in real terms, we are facing some potentially anemic years of economic performance.

What are the implications for our lending portfolios and our banks of a stagflation sort of environment?

What are the things we might do now to anticipate such an external environment and better prepare ourselves and customers for it?

We'll explore some of these issues in the weeks to come.

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- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

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