

Remarks by
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Federal Reserve System
to the
Better Business Bureau of Central Alabama
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It is a genuine pleasure to be with you here in Birmingham today. It is roughly twenty years since my last visit and what a change! The dynamics of this whole area are impressive, and I suspect this organization plays an important quality assurance role in this local business economy.

I wouldn't venture to comment on the local economy or even on the economy of the Sixth Federal Reserve District. But, I will attempt some general observations about the U.S. economy, including a quick look into my cloudy crystal ball for a peek at the future.

Let me start by saying that I believe we are well into a genuine recovery. It is not a typical post-World War II recovery. It is characterized by a more modest rate of growth and is uneven over the various segments of the economy and the geography. The 2.4 percent real growth in GDP in the first quarter should be followed by a similar rate of growth in the second quarter. I expect improvement in that rate in the second half of the year so that the performance fourth quarter 1991 to fourth quarter 1992 will be in the range of 2.5 to 3.0 percent in

real terms. That is somewhat slower growth than has been typical of postwar recoveries, but it is compatible with continued progress toward stable prices. It is also reflective of the fact that there are some unusual circumstances this time around.

-- We are in the midst of a massive cutback in defense spending which will result in the virtual elimination of many kinds of jobs. For example, builders of nuclear missile launching submarines. There may be skills there that are not as easily transferrable as those of, let's say, a bank clerk.

-- Individuals and corporations are still working off the hangover effects of the debt binge with which they indulged themselves in the Eighties. Anxiety over this process in the midst of recession has undoubtedly cooled consumer ardor for a return to full spending and slack demand has slowed recovery.

-- The last few years have been characterized also by many massive reorganizations of corporations to eliminate unprofitable businesses, reduce operating costs, and restructure debt. Large-scale reductions in staff have resulted in tens of thousands of jobs perhaps permanently lost. Forty thousand in the banking industry alone last year. This not only reduces the buying power of the newly unemployed, but unnerves their neighbors and friends to the point of undermining their confidence and reducing their propensity to spend.

-- The economies of many other of the industrial countries like Japan and Germany have also slowed, and some have been in recession, including France, Great Britain, and Canada. As a consequence, exports which have been a mainstay of our economy in

recent years, cushioning the depth of our own recession, cannot be counted on to add a vigorous growth rate to our recovery.

-- And housing, which has been a major engine of recovery in other times, has been more sluggish this time because of dampened consumer confidence about the long-term outlook and the stubborn refusal of long-term mortgage rates to come down much below the nine percent threshold.

But do not be downhearted. The current rate of growth is not likely to rekindle inflation and I see it continuing at 1992 levels or a little higher in 1993.

Bankers are an important part of the recovery equation. Their willingness to respond to demand for credit as it develops is essential. So let's take a few minutes to look at banks and their ability to finance a growing economy.

The banking industry is just coming out of the intensive care ward and the self-appointed team of doctors who dwell on Capitol Hill in Washington has prescribed a course of treatment in the Federal Deposit Insurance Corporation Improvement Act which might send it right back to intensive care, and in a comatose state.

The Eighties were clearly the worst decade for banks in the United States since the Thirties and the banks probably have no one to blame but themselves. The inflation psychology that said everything was always going up fostered risk-taking of unprecedented proportions. When those chickens came home to roost, shock wave after shock wave battered the banks. LDC defaults, the oil price collapse, the LBO and junk bond orgy, the commercial real estate boom and bust, which is still not over,

and a sluggish economy all undermined collateral values and the ability of troubled borrowers to earn their way out. The Gulf war made us proud of our power, but coming on top of the other trauma of the decade it precipitated a malaise among consumers and a collapse in confidence which sharply reduced demand, contributing to a less than exuberant economic performance and further compounding the problems of the banks.

Massive charge-offs and loan loss provisions necessitated painful restructuring of bank balance sheets, asset sales, downsizing, stringent cost management, and large-scale staff reductions. And it is not over yet. The emerging commercial real estate problems in Southern California and the impact of the Olympia and York bankruptcy have yet to be fully reflected in bank financial statements.

In short, we blew it. Bankers must in the final analysis accept full responsibility for this disaster of the awful Eighties and the nasty Nineties. They failed to appreciate the significance of what was going on around them. Bankers were like Captain Smith of the Titanic. They ignored the iceberg warnings and sailed on full steam ahead with predictable results.

It is our challenge to see to it that history does not repeat itself. Another calamity of the dimensions of the thrift industry collapse and the recent skein of bank failures might seriously threaten the private ownership of the system.

A glance at history provides a useful lesson. Excesses of greed and fraudulent management practices by the railroad moguls in the post-Civil War era prompted the establishment of the Interstate Commerce Commission to regulate the railroads. With

the best of intentions, the regulatory zealots managed to bring about the worst of results. In refusing to recognize that railroads were transportation companies, they restricted them to running trains of cars on steel rails and forbade them expansion into trucking, busing, or airlines, which were the transportation competitors ultimately responsible for the failure of many railroads and the nationalization of rail passenger service.

Congress is already threatening to smother banking in restrictive, unnecessary, unwise, and over-burdensome regulation. Another punishing round, precipitated by another season of failures, could put the finishing touches on the industry. Congress is unwilling to recognize that banks are financial enterprises and as such ought to be able to affiliate with other financial enterprises, most particularly securities firms and insurance companies.

And that stubborn unwillingness to recognize reality puts banks at an increasing competitive disadvantage both at home and abroad. European and Canadian banks have long enjoyed securities powers. And, in addition, British banks are permitted to affiliate real estate brokerage operations. In Japan, where Glass-Steagall-like barriers between banking and the securities business were written into the law during the occupation after World War II, the Diet is now considering legislation to permit affiliation between banks and securities firms.

Many European countries now permit common ownership of banks and insurance companies. In Canada, Parliament has a bill pending to permit ownership ties between banks and insurance companies. And none of the countries I know build geographic

barriers around their banks. By contrast, we have found it impossible to authorize interstate branching or insurance powers, and the obstinate refusal of one powerful committee chairman in the House has repeatedly blocked full participation by U.S. banks in the securities business.

Not content with continued restrictions on the financial diversification of the industry, the Congress has now embarked on an experiment in micro-management of the banks. The FDIC Improvement Act is the epitome of regulatory overkill.

In implementing the Act, regulators must require that banks report branch closings, small business loans, small agricultural loans, and interest rate exposure. Regulators must require auditing and Truth in Savings procedures which in my judgment are not needed and only increase operating costs.

The new risk-based premiums for deposit insurance can, in one sense, be likened to the old medical practice of bleeding a patient. The sicker the patient, the more blood the doctors drew. You know, poor old George Washington caught a cold while riding horseback in a snow storm and his physicians promptly bled him to death. Under this new risk-based premium scheme the weakest banks must pay the highest premiums. One might argue that is a way to assure and hasten their failure.

In addition, in this wonderful piece of legislation, regulators are required to establish standards for compensation of bank officers and directors, for internal controls, for interest rate exposure, for asset growth, for minimum earnings and for the ratio of market value of the stock to book value. Tons of additional burden both on banks and regulators with

little or no contribution to safety and soundness and no practical means of enforcement.

If Congress is going to micro-manage banking, banks may have difficulty attracting and retaining directors to say nothing of managers. And a bank may be so inhibited as to earning opportunities and financial diversification that it will not be able to raise capital at an acceptable cost.

I believe banking is still the most exciting business of all. What other industry touches every aspect of society and commerce. Banking provides service and credit to individuals, to every level of government, to farmers, to merchants, to manufacturers, to research scientists, to entrepreneurs, to educators, to religious groups, and, yes, even to Members of Congress now that their private bank is closed.

Bank credit is the life-blood of the economy and bankers have the responsibility to administer it to the benefit of borrowers while at the same time protecting the investment of depositors and shareholders. That is a much more sophisticated assignment today than ever before.

Banking is essentially the management of risk. The greatest danger in the recent trend of federal bank legislation is to make bankers so risk averse that the flow of credit to businesses and individuals is insufficient to sustain a healthy rate of growth in the economy. The much publicized "credit crunch" of recent years may indeed have slowed the rate of recovery from the 1990 recession. More important, perhaps, is the possibility that risk aversion, rooted in fear of examiner or Congressional retaliation, will stifle needed innovation in lending and even

cause some institutions to abandon segments of the market under close scrutiny by examiners. A case in point would be the commercial real estate market where bank credit sources have essentially dried up in certain parts of the country.

But, it is well to note that, in spite of the political cloud on the distant horizon, the sun is once again beginning to shine on the banks. The industry earned record profits in the first quarter of this year. Equity capital ratios are at their highest levels in more than twenty years and balance sheets are better proportioned than at any time in the Eighties. Reserves are in sounder relation to asset values and both management and directors acknowledge that lean and tough is the proper corporate stance for those who intend to survive.

And it will be a very different industry in the year 2000 than it is today:

-- Because I am an optimist, and because I believe common sense will ultimately prevail, I expect Congress eventually will repeal much of the nonsense in FIRREA and FDICIA. I also expect that real financial reform legislation will pass and banks, insurance companies, and securities firms will be allowed to affiliate to provide integrated financial services to individuals and businesses, at less cost.

-- I believe Members of Congress will reverse their recent course because they will finally be convinced that bankers know better how to run a bank than they do.

As a result of legislative reforms and integration, by the year 2000 there will be perhaps ten huge financial conglomerates,

based on a core of commercial banking, operating banks and branches essentially nationwide.

There will be another twenty-five or thirty super-regionals with lesser geographic reach but similar integration. And there will be seven or eight thousand community and subregional banks, with elements of integrated services, which will be fully competitive because they will concentrate on values considered important by much of the public. Those values are prompt personal service and identification with the local community and its needs.

In the final analysis, the health of the U.S. economy is greatly dependent on the health and competitiveness of the financial system. Banks are the centerpiece of the financial system and provide access to the payments system for all elements of society.

In the developing global economy and a 24-hour global capital market, the United States financial system must be allowed to integrate in order to compete effectively with the increasingly integrated financial systems in the rest of the industrial world. I am confident that the Congress will perceive that reality in the near future and initiate the bold moves necessary to implement it.

Thank you for your attention and I would be delighted to answer questions as time permits.