Remarks by

John P. LaWare

Member, Board of Governors of the
Federal Reserve System

to the

Algonquin Club

Distinguished Speaker Series

Boston, Massachusetts

February 17, 1993

Good afternoon. I can tell you right now that it is great to be home nd to be in the familiar surroundings of the Algonquin Club, to be in Boston where politics is a passionate hobby instead of an all-consuming life purpose.

I want to speak with you today about some things which are on my mind and I hope on yours. First, the economy -- not the New England economy which I am sure you have analyzed and agonized over to the point of no return -- but rather the national economy. Where we are today, in my opinion, and where we might be headed in the months ahead.

Next, I want to talk briefly about the so-called credit crunch, what it is really all about, and what the future may hold on that front.

Finally, I want to comment on the condition of the commercial banking system and the outlook for the industry in the

context of impassioned cries for regulatory relief and structural reform.

The United States economy is doing better currently than even the most optimistic forecasters would have dreamed only 6-8 months ago. With reported growth in real GDP of 3.4 percent in the third quarter and 3.8 percent in the fourth quarter, unemployment nationally has retreated from a high of 7.8 percent of the work force to 7.1 percent in January, and inflation is running below 3 percent on an annualized basis. Short-term interest rates are at their lowest level in more than two decades and the 30-year Treasury bond yield is just over 7 percent.

These are conditions conducive to growth and key segments of the economy have responded. Housing starts have improved significantly and that activity brings improved conditions to the businesses of the many suppliers who support housing construction. Lower interest rates are contributing to revitalized sales of existing homes. Sales of autos, particularly U.S.-built autos, have picked up. Industrial production is growing. The inventory-to-sales ratio of U.S. businesses is at a very low level. This has triggered, and should sustain, an increase in inventory investment through 1993 and 1994. Retail sales are stronger than expected and personal consumption expenditures have returned to their strongest rate of growth since 1988 after a period of two years when consumers were more intent on reducing their personal debt burden than on acquiring more goods, particularly durables.

Remember, I am speaking now about the macro-economy -- not regional economies. New England remains very sluggish, Southern California is showing signs of continued deterioration, and the Pacific Northwest is soft due to the dramatic slowdown in commercial aircraft orders and restrictions on timber harvesting. The Mid-Atlantic states are doing better, and the Southeast states, the rust belt, and the plains states continue to look quite healthy.

At the same time, the outlook for inflation in 1993 and 1994 is for a continued downward trend approaching an annual rate of 2 percent or less by 1995.

The challenge from the point of view of pure economics is to sustain present trends. The political challenge is the need to improve the job environment, since the average voter measures the health of the economy by the unemployment numbers and the difficulty in finding work.

The economic challenge may be tougher to meet than the political one. There is a lot of soft ground out there which could bog down even as strong a growth pattern as we are now experiencing. The current expansion is largely consumer driven and, in my opinion, results from a renewal of consumer confidence, beginning in August. I think the Democratic Convention sounded an upbeat note which was contagious. But, I also think the public began to feel that, whichever candidate won the election, the economy was going to receive more attention and

things would be better. Clinton's victory, based on more pro-active campaign promises, lifted expectations and moved confidence up the scale.

But confidence is a fragile, psychological phenomenon which needs nourishment and reinforcement. The question now is: will confidence survive what lies ahead?

Tonight we will hear the details of the President's plan for the economy. Almost certainly it will contain spending proposals to create jobs. That is a prime expectation and will be received eagerly by those who are out of work. But if the proposals are for spending on rebuilding the physical infrastructure of the nation -- roads, bridges, railroads, and airports -- will it do much for the displaced defense production employee, the military serviceman returning to the civilian work force, or the computer technician laid off in the restructuring of that industry, or the middle manager from a bank or insurance company, who is out of work because the company that employed him has had to thin management ranks in pursuit of greater competitiveness?

What will happen to the confidence of a member of the middle class who has been planning on a tax cut since last November, but is now faced with a tax increase to reduce the budget deficit, which is, in itself, a concept hard to relate to?

How will the Gray Panthers feel about higher taxes on their Social Security income?

How will those in the higher income brackets react to higher taxes on their income? Will they continue to increase their consumption? More important, will they continue to invest in American business or will they and their middle class compatriots turn cautious, slow down spending and investment, and help choke off this strong recovery.

Attitudes are of enormous importance in this environment and a great deal depends on the President's ability to sell the nation a menu of sacrifice without squelching the confidence which is fueling the current growth pattern.

If he succeeds, then the outlook is favorable and my personal forecast would be for growth in real GDP of 3 to 3½ percent in 1993, with inflation, as measured by the consumer price index, falling to the 2½ to 2¾ percent range. Unemployment tends to lag somewhat but by the fourth quarter of 1993 I would expect it to be between 6½ and 6¾ percent of the labor force.

But, if the President's program as proposed tonight and subsequently implemented by Congress is seen as too sacrificial and not enough beneficial, then the pace of economic growth could slow dramatically, and, perversely, the expected improvement in employment could abort. Corporate restructuring will, in my opinion, continue to be a fixture of the Nineties. And, the race to improve productivity is not consistent with rehiring those who have been laid off. Moreover, much of the rest of the world,

including our major trading partners, is in the doldrums, lagging our own recovery and dampening the growth of our export sector. And the depressed state of the commercial real estate sector is likely to continue for some time. The recovery, therefore, has its fragile elements and the needed efforts to reduce the deficit may, in themselves, be counter-productive to sustaining our present rate of growth.

An important issue in the debate over the sustainability of the recovery is the "so-called" credit crunch. I say "so-called" credit crunch because this current phenomenon does not fit the classic definition of a credit crunch. Classically, a credit crunch is when the demand for credit far outstrips the ability of the financial system to meet the demand. In the current instance there is ample capacity to lend in the banking system and there has generally been only slack demand.

This is a phenomenon which has both supply and demand elements in it, on a selective basis.

On the supply side, the battered and still bruised commercial banking system has been through a series of trauma which have imposed priorities on lending policies which do not necessarily apply to all applicants for credit. Certainly, given the state of the commercial real estate markets in most parts of the country, the availability of credit for commercial real estate development is restricted to pre-leased and pre-permanent financed facilities with developer equity and take-out

guarantees. That is not hard to understand given the experience of failed banks brought down by non-performing real estate loans, or survivor banks whose capital accounts were decimated by charge-offs and higher reserve requirements. And, given the current state of commercial real estate markets, with up to ten years' supply of inventory, it is not hard to understand why developers find credit hard to obtain. Interestingly , some of the loudest complainers are the ones who did not pay back their loans last year.

In addition, many would-be business borrowers, both large and small, have themselves been hurt by the recession and recent business conditions. This makes their balance sheets and operating statements less attractive to loan officers at the same time that banks are tightening lending standards to avoid future mistakes.

Add to all of that higher capital requirements for banks at year-end 1992. This one factor caused many banks actually to down-size their balance sheets to improve capital ratios. In part this was accomplished by asset sales. But many banks also restrained loan originations, particularly in loan classifications where they felt they were over-concentrated. Finally, many banks simply stopped making certain types of loans because the documentation requirements to satisfy over-eager examiners or secondary market requirements made it unprofitable to originate the loan given the pricing structure of the market. This is particularly true of mortgage loans and small business loans.

Another factor in credit demand is need. In past experience, the early months of a recession often put heavier credit needs on businesses due to slower receivables and inventory. In recent years, we have had a major revolution in inventory management to the extent that it substantially reduced the need for inventory financing as the economy slowed.

And, indeed, a slower growing economy ultimately produces less demand for credit due to a lower level of commerce.

Add to all of these factors overzealous application of examination standards, especially by young, inexperienced examiners who use a cookbook approach to their job, and you have the recipe for slower credit growth and the feeling of many applicants that they are being dealt with arbitrarily. On the other side of that argument would be the banks who would plead self defense. Self defense against the repetition of previous mistakes, self defense against higher capital standards, self defense against concentration in troubled industries, and self defense against restrictive and suffocating regulation often administered by inexperienced examiners and indifferent supervisors.

This was not so much a credit crunch as a credit reallocation to satisfy external forces which changed bank management behavior in a major way and also affected the credentials of prospective borrowers.

In conclusion, I would like to discuss briefly the condition of the banking system, the burden of over-regulation, and the urgent need for substantial structural reform in the United States financial system.

The condition of the commercial banks in the United States taken in the aggregate is probably the best it has been in more than two decades. Capital is at its highest level in relation to assets in 25 years. Earnings are at record levels with the return on average assets of the nearly 12,000 banks at about one percent and for the 50 largest at .83 percent. There are literally only a handful of banks in the country who do not meet the minimum risk-based capital standards, and there are less than 50 who are considered critically undercapitalized and therefore subject to government intervention. And those deeply troubled institutions have aggregate assets of less than $7 billion, so even if all were intervened tomorrow, their resolution would not constitute a threat to the solvency of the FDIC, in spite of all the wild claims of some academic researchers.

Much has been made of the increase in the Treasury security holdings of banks and coincident decline in the C&I loan portfolio. The allegation is that banks are playing the yield curve and the lower capital allocation for Treasuries at the expense of businesses which need credit support. It is true that the risk capital allocation for Treasuries is zero while it is 8 percent for commercial loans. But ask yourselves what bank would long survive if they put depositors' money only into Treasuries

and denied deposit customers access to loans. I believe from my own 35 years of experience in banking that in the absence of strong loan demand banks invest in highly liquid securities, with the intent of liquidating securities to make loans as demand develops. This has been the pattern in the past and will be in the future as well. I have no doubt that banks will finance the growth in the economy, because that is their business, their reason for being.

I have spoken at length about the economy and about banks and their ability to finance the economy. Now I want to comment on the much more serious and fundamental question of the survival of banks as meaningful competitors in domestic and international markets.

In a well-meaning attempt to assure the safety and soundness of banks, protect depositors, and ultimately limit the liability of taxpayers, Congress has enacted over the years a plethora of statutes, the implementation of which has created a costly and stultifying burden of regulation on commercial banks, restricting severely the activities in which they may engage and more recently imposing management procedures, reports, and controls which add enormously to cost and arguably accomplish very little in assuring sound operation.

In addition, there are a number of statutes enacted ostensibly to protect consumers, which are in effect devices to use the banking system for social engineering purposes. The

Community Reinvestment Act is a good example. Discouraged by the failure of public housing projects all across the country, Congress passed the CRA in 1977 to recruit the banks to solve this huge humanitarian problem, saying banks derive deposits from the community, therefore they are obligated to make sure the credit needs of that community are being met. Private capital has always been more efficient than government spending and that has been the case with CRA. And, indeed, an intelligent well-administered program can be profitable and desirable business for a bank.

But, the Act has been applied just as stringently to small banks in rural communities as to banks operating in the inner city where the real problem exists. As Congress has clamored for a more pro-active role for banks, supervisors have had to require more documentation to provide an audit trail to establish compliance, and the automatic protest of applications on the ground of CRA non-compliance adds enormously to the supervisory cost and the cost to the bank. Based on years of experience, I believe these protests have little validity. The overwhelming majority of protests are determined to be unfounded and without merit.

By limiting activities, circumscribing management prerogatives, and requiring banks to sponsor social programs, regulatory overkill is making banks increasingly uncompetitive and essentially forcing customers to other sources of financial service: brokers, investment bankers, insurance companies,

mutual funds, and finance companies. If this trend continues, banks will cease to exist as innovative risk managers, providing new credit and deposit services to an expanding economy. I do not think that is enlightened public policy.

What, then, might happen to change that gloomy outlook. Well, the question has Congress' attention and has stirred deep concern in the industry. Congress asked the Federal Financial Institutions Examination Council to study unnecessary regulatory burden and we submitted a comprehensive report on the subject last December. I will be testifying in the House tomorrow on the findings of that study and later in the spring we will submit recommendations for specific legislative action to remediate some of the burden. I am hopeful that this will lead to significant action, but not overly optimistic.

I am even less sanguine about structural reform which has been needed for many years. Repeated efforts to focus Congressional attention have been thwarted by those in the leadership who are the captives of special interests opposed to any move to broaden the powers of banks or permit the integration of the financial services industry. Meanwhile, the rest of the industrial world, our major trading partners particularly, have moved aggressively to permit the affiliation of banks, securities firms, and insurance companies. Safety and soundness concerns about such affiliations are unfounded, based on long experience in other countries. But these concerns have been used as a

smoke-screen to cover the catering to special interests who profit from an emasculated banking system.

These issues have become so politically sensitized that normal Congressional or Administration initiatives may not accomplish much. To break the impasse, I have suggested that a non-government commission be appointed to study the competitiveness of the U.S. banking system both domestically and internationally and make recommendations to Congress. This might defuse the political sensitivities sufficiently for Congress to take decisive action independent of pressures from the special interests.

I have tried to cover a lot of ground. In short, the economy is OK for the moment, but vulnerable. The credit crunch isn't what it's represented to be by the pundits. And the banking system is currently healthy but subject to secular decline and extinction if regulatory and structural relief is not forthcoming.

#