

**THE ECONOMIC OUTLOOK FOR THE SOUTHEAST  
AND DEVELOPMENTS IN BANKING**  
Remarks by Robert P. Forrestal, President  
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To the Board of Directors of the Citizens and Southern Corporation  
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**I. Introduction:**

- A. When Bennett Brown extended the invitation to be with you this morning, he asked that I talk about the southeastern economy and current banking issues.
- B. Either of those topics could fill the allotted time; addressing both enforces the discipline of conciseness.
- C. I'll begin with a look at the region's economic prospects for the year ahead and then discuss several major issues affecting the development of our industry.

**II. Economic Conditions and Prospects for the Nation**

- A. The Southeast's economy will be affected by the main factors that will determine the economic prospects for the nation as a whole
- B. Look at national economy over the next year in terms of the three major indicators—gross national product, unemployment, and inflation—before narrowing our focus to our own region.
  - 1. GNP should continue to expand at a rate of 2 1/2 percent or even a bit faster this year.
  - 2. June unemployment was 6.1 percent, continuation of decline from 1986 level of 7 percent. Expect rate to stand at around 6.2 percent by year's end and drop toward the 6 percent range in 1988.
  - 3. Inflation should accelerate from last year's average pace of less than 2 percent as measured by the consumer price index to 4 1/2 or even 5 percent over the next 12 months.
- C. The higher prices in my forecast partly due to international factors, though by 1988 there is potential for wage pressures to develop.
  - 1. reversal of last year's downward movement in prices
  - 2. rise in other import prices, which as of last year were up 8 percent.
  - 3. unemployment rate at 7 year low and close to "natural rate."
- D. International sector also critical to the outlook for GNP growth.
  - 1. Consumption will not be the main source of growth in the economy as it has been in recent years.

- a. income growth hasn't been all that strong, though assets are high in concert with gains in the stock market and home values.
  - b. Debt-to-income levels are also very high, though, and the savings rate has fallen to quite low levels.
2. Investment is unlikely to lead growth either.
- a. A temporary need for new investment to replace the considerable drawdown of inventories in the last quarter of 1986 cleared stocks and set the stage for the strong growth in the first quarter of this year.
  - b. Business investment has been declining partly because of low capacity utilization but mainly due to the overbuilding of offices and retail space.
- E. Government purchases will provide much less fiscal stimulus than in the past as the budget deficit is smaller than it was.
- F. This leaves us net exports as an engine for the expansion, and an improvement in the U.S. international sector is expected because of the decline in the value of the dollar in foreign exchange markets
- 1. the dollar has been declining for over two years now
  - 2. real net exports have improved for the past two quarters.

### III. Outlook for the Southeast

- A. The turnaround in the trade deficit along with the stabilization and even firmness in energy prices will also affect the economy of the Southeast.
- 1. The economies of Alabama and Tennessee as well as much of rural Georgia are more oriented to manufacturing and as such have been facing many of the same foreign trade-related difficulties as the nation.
  - 2. Stabilization of the energy sector will be especially important to Louisiana and parts of Mississippi, both of which have been adversely affected by the sharp fall in oil prices last year.
    - a. There is reason to hope that things have bottomed out.
    - b. If oil prices remain near or even a bit below current levels we could see some exploration—especially for natural gas.
  - 3. In contrast, the service-based economies of Florida and certain metropolitan areas in other states have been doing quite well and seem likely to continue on that path.
- B. agriculture will be a lingering area of weakness, not only during 1987 but perhaps for several years to come.
- 1. Heavy indebtedness incurred during periods of prosperity will continue to

go unserved, resulting in additional bankruptcies and foreclosures among borrowers and loan losses for lenders.

2. Farmers in the Southeast stand to gain less from expected international developments than, say, the Midwest, because they don't produce as many crops for export.
- C. Likewise, any improvement for the region's manufacturers deriving from the realignment in trade would probably not be dramatic in the short run.
1. The apparel industry, for example, faces import competition from the newly industrialized countries of the Pacific rim--Taiwan, Hong Kong, and Korea.
  2. The currencies of those countries have only recently begun to move up slightly against the dollar, and so U.S. apparel makers have not had as much relief from import competition as have other industries.
  3. Similarly, the region's important lumber industry continues to feel the effects of relatively cheap Canadian dollars.
  4. The textile industry, which also competes with cheaper products from abroad, has taken an aggressive approach to the problem and rebounded to better health.
    - a. By substituting capital for labor, fabric and carpet producers were able to turn record profits last year.
    - b. Unfortunately, this adjustment won't save jobs, since more efficient producers need fewer workers to produce the same amount of goods.
- D. Other locally important industries are likely to face mixed prospects this year.
1. Auto and related manufacturing, which is a significant and growing economic activity in Georgia, Tennessee, and Alabama, may not have as strong a year as last if consumer spending for durables remains sluggish at the national level.
  2. Defense contracts are the bread and butter of many of the region's electronics producers as well as makers of transportation equipment like aircraft, but government spending is not likely to increase and could possibly decline.
    - a. Much of Florida's industrial sector produces electronic and transportation equipment tied to the defense and space programs, and the resumption of serious work on the space shuttle would have positive effects for numerous private industries there.
    - b. The lower dollar's effect on prices of electronic parts and products abroad should bolster high tech manufacturing in Florida and elsewhere to some extent.
- E. Population growth, a unique regional factor, will continue to be one of the

most positive factors in our growth.

1. Continuing inflows of people and corresponding gains in employment and personal income are major reasons for the more rapid growth of Florida and Georgia.
  2. Florida's population has expanded at a rate three times as fast as the national average in the 1980s.
  3. The influx of new residents stimulates demand for new houses, apartments, offices, and retail space, in turn making for a bustling construction industry.
  4. Recent arrivals also generate greater demand for a variety of services ranging from schools and hospitals to recreation and the whole gamut of retail establishments.
  5. Expectations of continued growth nationally suggest that movement to the Southeast will persist, since most people who want to relocate will be able to sell their homes elsewhere.
  6. In addition, the dollar's decline along with gasoline prices that are lower than in the past should continue to bolster tourism
    - a. The lower dollar translates into more visitors from abroad as well as more domestic travel by Americans.
    - b. Florida attracts more overseas visitors than any other state.
  7. Tourism tends to stimulate demand for services and trade in much the same way that permanent population growth does.
  8. Together, these factors should lead the region's total employment to increase by about half a million new jobs in 1987.
- F. Construction—the other population-driven economic sector—will not, however, do as well as one might expect, given the anticipated amount of population expansion.
1. Apartments and condominiums are overbuilt and the market has been declining for some time.
  2. Commercial construction is likely to be weak due to:
    - a. effects of the tax law change on business investment
    - b. and the fact that many local markets were substantially overbuilt in recent years and need time for all the new space to be absorbed.
    - c. still, absorption rates in the South are faster than elsewhere.
- G. On balance, though growth in the region may decelerate somewhat from last year, it is still likely to be fast enough on average to stay ahead of the nation.

#### IV. Issues in the Banking Industry

- A. In the time remaining, I'd like to discuss some of the major issues involving the banking industry.
- B. We are all aware of disturbing signs of weakness
  - 1. A recent study at the Atlanta Fed shows bank profitability declined further in 1986, particularly among the smallest institutions.
  - 2. This would suggest that bank failures, 138 of which occurred last year—the highest in any single year since the Depression, will probably continue in large numbers.
  - 3. Indeed, in the first half of 1987, 96 more banks failed.
  - 4. But failures are not likely to have systemic effects.
- C. Rather than dwelling on present weaknesses, however, I'd like to focus on the future of the industry as a whole by looking at the direction of deregulation and touching on how the "new" banking legislation would affect the industry's evolution.
- D. **Deregulation:** As representative of one of nation's chief regulatory agencies, I endorse the Fed's consistent position in favor of the long-term goal of deregulation in financial markets.
  - 1. Deregulation offers clear efficiencies and advantages to the consumer that are not likely to occur in an environment of strict regulation.
  - 2. The key term here is "long-term goal."
    - a. Too often situations have built to crisis proportions before action is taken.
    - b. In looking ahead, we need to be guided by a vision of a banking industry that
      - (1) gives vent to the creative forces of the market on the one hand
      - (2) but on the other protects the legitimate interests of depositors and taxpayers from the hazards posed by the underwriting of risky ventures when government insurance is available.
  - 3. Thus the long-term solution should be a balance of deregulation and strengthened, but limited regulation—admittedly a challenge.
  - 4. That balance should in my opinion address certain specific problems.
  - 5. On the deregulation side of the ledger, more work needs to be done with regard to:

- a. **geographic markets:** we should adopt a more systematic approach at the national level toward full-scale national interstate banking.
  - (1) There are still 5 states without provisions for interstate banking, and in most states that have such provisions a hodgepodge of geographic limitations make regulation more difficult.
  - (2) Most interstate laws now on the books prohibit de novo entry.
  - (3) The lack of effective interstate banking deprives customers of competitive choices in prices and services.
  - (4) It also encourages exploitation of the nonbank loophole by financial organizations, a roundabout approach that probably wouldn't be necessary if banks were free to open up full-service offices wherever they liked.
  
- b. **product diversification:** banks should be allowed to compete against nonbank firms that offer competing products by expanding banks' permissible products and services.
  - (1) Banks should be permitted to provide insurance to domestic customers.
  - (2) The reasonable safety record of banks in underwriting corporate offerings abroad suggests that prohibitions against the same activities in this country are unreasonable.
  - (3) lift prohibition of interest payments on corporate demand deposit accounts.
    - (a) current arrangement encourages unnecessary funds transfers by large corporations seeking a market rate, adding to systemic risk by increasing amount of funds flowing through payments system.
    - (b) prevents small businesses from earning a return on excess balances.

6. Strengthened regulation is called for in several areas:

- a. **More comprehensive oversight of off-balance sheet items**
  - (1) proliferation of products like standby letters of credit, interest rate swaps, and so forth could lead to insolvency, not only of institutions immediately involved but of their insuring agencies and depositors as well because they understate the amount of risk relative to capital.
  - (2) Obvious solution is to have requirements—ones that are imposed in coordination with the international banking community—that capital be adequate to back up off-balance-sheet items and do not permit inappropriate risk taking.

- b. In the payments system, **electronic payments** require more attention.
    - (1) The fact that a sizable fraction of large-dollar payments remains provisional for periods of many hours poses the danger of disruption
    - (2) Use of free credit in large-dollar payments encourages economically unsound transactions and possibly increases risk.
    - (3) The present large-dollar payments arrangement encourages market participants to set prices that fail to take account of risks to third parties.
  - c. **Deposit insurance** is an issue that cannot be solved simply by deregulation.
    - (1) Most pressing problem is FSLIC.
    - (2) Here again, in the long run risk-based capital requirements would provide a cushion for the insurance funds and help buffer the industry from systemic risk.
    - (3) We also need to let the market do part of the work
      - (a) We could impel uninsured depositors and holders of subordinated debt to exert more surveillance and discipline on institutions they patronize.
      - (b) FDIC proposals for limited payout of uninsured deposits at failed banks and for greater disclosure of banks' financial condition embody this approach.
- E. Is the **new bank bill** as it emerged from the conference committee a step toward realizing the objective of moving away from ad hoc measures toward viable long-term solutions?
- 1. It provides only one new bank power while placing a moratorium on any other expansion for one year.
    - a. It eases current restrictions on national banks' leasing powers to allow them to compete more equally with thrifts and others in the lease-financing business.
    - b. But ties the hands of regulators from permitting banks to engage in any securities activities not legally authorized before March 6 of this year and extends Glass-Steagall's underwriting prohibitions to state-chartered banks that are not members of the Fed.
    - c. This clearly does not further the objective of further deregulation in a timely manner.
  - 2. It closes the nonbank loophole, no doubt a good thing in the long run.

3. It would recapitalize the FSLIC with between \$7.5 and \$8.5 billion, depending on how one measures it, but this is an amount that I think is quite inadequate to do the job.
  4. And the bill grants regulators permanent emergency powers to facilitate mergers of failing banks—a positive move.
  5. In sum, the bill is a piecemeal measure falling short in two critical areas—expanded banking powers and sufficient recapitalization for FSLIC.
- F. Ultimately we need most to get away from our ad hoc approach to the regulatory issue and adopt a broader perspective appropriate to developing market conditions.
1. ad hoc measures simply encourage institutions to find and exploit loopholes
    - a. either by developing new products
    - b. or, in the globalized market, by going offshore.
- G. In my opinion, the way to systematize regulation is to give banks the expanded powers I mentioned earlier while at the same time clarifying the fundamental historical principle of financial regulation in the United States—the separation of banking and commerce.
1. I don't see how the separate activities of a company involved in diverse financial activities can be separated so that depositors can be assured funds would not be diverted to avert failure in some other part of the company.
  2. Nonfinancial companies ought not to be allowed to offer banking services.
  3. By the same token, banks should not be entirely like nonfinancial companies because they cannot be expected to isolate themselves effectively from risky activities undertaken by nonbank subsidiaries.

## V. Conclusion

- A. We've seen that the nation's economy is poised to continue growing at a moderate rate and that the Southeast is likely to outpace the rest of the nation in its growth.
- B. The nation's banks suffer short-term profitability problems and uncertainty over the long-term regulatory framework.
- C. The industry must keep pushing for true solutions rather than temporary stopgaps that undermine competitiveness.
- D. At least in the Southeast our banks still outperform those in the rest of the nation.