

**THE ECONOMIC OUTLOOK FOR THE THE SOUTHEAST  
AND CURRENT ISSUES IN BANKING**  
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to the Board of Directors of the First Atlanta Corporation  
October 20, 1987

Good afternoon! I am pleased and honored to have this opportunity to meet with the directors of the First Atlanta Corporation. When Raymond Riddle extended the invitation to be with you this afternoon, he asked that I talk about the outlook for the southeastern economy and current banking issues. Either of those topics could fill the allotted time, but attempting to address both of them at least has the virtue of enforcing conciseness. Of course, numerous themes bridge economics and banking, but one in particular—the increasing globalization of markets—has come into prominence in my thinking. The linking of networks for transferring large amounts of money around the world 24 hours a day and the increasing presence of Japanese and European bankers in our domestic banking market forces all of us to begin thinking as internationalists even as we are coming to grips with rapid and substantial changes inside our own borders. Thus you will find references to international economic developments in the background of many of my remarks today. I'll begin with a review of the national outlook since what happens in the nation as a whole will determine in large measure the prospects for economic activity in our region. Then I'll turn to a brief discussion of current issues in banking including the influence of international events.

### **The National Economic Outlook**

As you know, there are three basic measures of performance commonly used to gauge how the nation is doing, economically speaking—gross national product, unemployment, and inflation. I look for real GNP to expand once again this year at a rate of about 3 percent, and to come in a bit under that in 1988. Unemployment has

fallen from the 7 percent level, where it remained lodged most of last year, to 5.9 percent in September. I am hopeful that it will remain in that range, which is a seven-year low and close to what I consider the "natural rate" of joblessness. Inflation should accelerate from last year's very low pace, as measured by the consumer price index, to as much as 5 percent in 1987 before probably dropping back a little in 1988. The higher prices in this forecast are in large part due to international factors. These include not only the lifting of oil prices from very low levels but also the rise in other import prices, which as of mid-year were up 9 percent. However, I now expect inflation to moderate somewhat in late 1987 from earlier in the year because oil prices seem to have plateaued and food prices have been easing at the wholesale level.

Still, the Fed did act last month to reduce the potential for inflation to worsen, and we raised our discount rate from 5 1/2 to 6 percent. At the same time, market rates of interest have ratcheted up far more and to their highest levels in two years. Concern about the failure of our trade deficit to fall in nominal terms and our resulting dependence on foreign financing has weighed heavily on market sentiment. These are major issues of concern, though I believe we will make some progress over time in reducing our reliance on borrowing from abroad. In fact, developments in the international sector are critical to the outlook for GNP growth.

I look for improvement in the foreign trade situation to be the engine behind our moderate rate of expansion, with some support from consumption. The deficit is already improving in real terms, though it takes longer to see it narrow in current dollars. The other major components of GNP—investment and government demand—are not likely to add to overall growth. I expect very modest growth in consumption over the remainder of this year and some strengthening during the next. We have seen an improvement in the manufacturing sector, and industrial production is now 4.5 percent higher than it was

last year at this time. The related growth in salaries in this higher wage sector should help bolster consumer spending. But this large component of GNP — about two-thirds — is not likely to be nearly as strong as in recent years—nor should we expect it to be. The low savings rate and high debt-to-income ratios that resulted from very high consumer spending growth will dampen these expenditures as we go forward.

Another factor retarding growth in the consumer component of GNP reflects the beginning of a long-term trend we at the Fed have been predicting for some time, namely, smaller annual increases in per capita consumption. This is largely the inevitable "morning after" following the spending binge that we as a nation have been on—both publicly and privately—almost since the start of this decade. Now we must embark on what will be a rather long period of paying back some of the debt to the rest of the world that we amassed to finance that binge. And, of course, we have to pay back not just the huge principal but also the ever increasing burden of debt service. The only way we can accomplish this is by consuming less of our own production and exporting more.

International developments will also have a bearing on investment, a small but important part of GNP. The fact that I look for exports to increase means that investment in equipment, factories, and warehouses should pick up. The positive effects of this capital spending will probably be mostly offset, however, by declining investment in offices, apartments, condominiums, and retail space. By treating some aspects of investment less favorably, changes in the tax code have exacerbated the short-run effects of overbuilding that occurred over the past several years. In time this should lead to a more efficient allocation of capital as the revised tax code encourages investment dollars to be distributed more in accordance with the dynamics of supply and demand. In the near term, though, we may see some uncomfortable adjustments develop

until excess space is absorbed. The market for single-family housing is also likely to be weak. Mortgage rates have been rising significantly, and both housing starts and permits are down from earlier levels. For these reasons, investment seems to be at a stalemate, neither pushing nor retarding GNP growth. As for government purchases, budget deficits are, thankfully, on a downward slope, but this, of course, means much less fiscal stimulus than in the past.

This leaves us with net exports as an engine for the expansion. An improvement in the U.S. international sector is expected for two reasons. The first is the decline in the value of the dollar in foreign exchange markets. While this factor works with a lag, the dollar has been declining for well over two years now and we have already seen an impact. In fact, exports began picking up in real terms in the last three months of 1986 while imports flattened. Real net exports—the exports less imports—have now improved for three consecutive quarters for the first time since 1980. The second reason to expect a turnaround in the trade sector is related to something that we are all concerned about, namely, that we cannot keep increasing our borrowing from abroad indefinitely. For some time now we have been spending more on consumption, investment, and government than we actually produce domestically. The substantial expansion of the federal budget deficit has contributed to this situation. To meet our financing needs, we have been borrowing from abroad. Of course, this cannot go on forever. Our creditors may become less willing to lend, and, just as any borrower eventually learns, debt service inevitably rises along with the debt and becomes a burden. So the time has come to start repaying. While GNP or national output will grow at about the same rate in 1987 as it did last year, more of that increase in output will be exported and less of it will be available for domestic use.

The inflation picture will be dominated by oil prices and shifts in international

trade. Prices of petroleum and other commodities are still well below their levels of a year ago. Without the kind of help from declining energy and commodity prices we enjoyed last year, however, the rate of price increase is likely to return to its pre-1986 pattern, though not to the unacceptably high levels we saw earlier in the decade. Meanwhile, rising import prices seem likely to send us to a higher rate than in 1985, when the Consumer Price Index rose 3.8 percent. As I mentioned earlier, though, the Fed's recent discount rate hike demonstrates our resolve to keep prices under control. Taking all this into account, I am confident that increased exports and substitution of domestic for some imported goods, along with the other factors I've discussed, will sustain the expansion for at least another year. We should be able to enjoy this sustained growth without unacceptable rates of unemployment or inflation.

#### **Outlook for the Southeast**

What does this outlook imply for the Southeast, which includes not only prosperous and fast-growing cities like Atlanta, Nashville, and most of Florida but also weak or even depressed places such as Louisiana? The main factors that will determine U.S. economic performance this year will also have a primary bearing on how this part of the country does. Stabilization of the energy sector is especially important to Louisiana and the parts of Mississippi that have been adversely affected by the sharp fall in oil prices last year. Lower unemployment rates in both states are evidence of improvement, though. I feel confident that they have reached bottom and are in position to begin to turn around. Nonetheless, the energy sector, together with agriculture, will be a lingering area of weakness in the Southeast.

On a more positive note, improvements in the trade balance should ultimately spell good news for many southeastern manufacturers who were subject to either intensified import competition or greater difficulty in marketing abroad after the dollar appreciated

in the early 1980s. One particular problem that affected many industries here is the failure of the dollar to depreciate against major foreign competitors such as Canada and the newly industrializing countries of the Pacific rim. Consequently, the Southeast's important forestry industry continued to be hurt by the influx of Canadian softwood. The same has been true of apparel makers who compete with clothing manufacturers in Taiwan, Korea, and Hong Kong. Fortunately, this situation has finally begun to show some progress. The new dollar index, developed by economists at the Atlanta Fed, in part to measure the differential impacts of currency changes on particular regions and industries, indicates that in the first nine months of 1987 the dollar fell more sharply vis-a-vis against the newly industrializing Pacific rim nations than the currencies of our other major trading partners. I expect these realignments to help. Still, foreign competition has led certain traditional southeastern industries to restructure through increased automation. This means that whatever turnaround the textile and chemical industry and others in similar situations undergo is not likely to have a dramatic impact on employment. Any rise in output will generate some new jobs, but employment gains will not be proportionate to advances in output.

Other locally important industries are likely to face mixed prospects this year. Auto and related manufacturing, for instance, which is a significant and growing economic activity in Georgia, Tennessee, and Alabama, may not perform as strongly as last year if consumer spending for durables tapers off at the national level. Defense contracts are the bread and butter of many of the region's electronics producers as well as makers of transportation equipment like aircraft. With spending by the federal government expected to slow, activities in these industries may be somewhat weaker.

Aside from the effect of macroeconomic factors like deficit spending trends, the trade balance, and consumer spending deceleration, the Southeast's growth is heavily

influenced by some unique regional factors. Probably the most important of these is population growth, or more specifically, in-migration. Continued growth in the national economy will make it easier for people who wish to relocate to the Southeast. Confident of their ability to sell houses in their present hometowns, these migrants can join the inflow of people to the region and spur corresponding gains in industries like trade and services. Population-driven growth in the demand for services ranging from schools and hospitals to recreation and the whole gamut of retail establishments is one of the major reasons for the relatively rapid employment and income gains of Florida and Georgia.

The in-migration of new residents typically stimulates demand for new houses, apartments, offices, and retail space, in turn making for a bustling construction industry. In the near term, we may see continued expansion in single-family housing for some parts of the Southeast. Other segments of the construction industry will not do as well as one might expect. Multifamily building, as well as construction of offices and retail space, is likely to be weak. The reasons for this apparent anomaly are the tax law changes, and the fact that in recent years many local markets in the Southeast were substantially overbuilt and need time for all the new space to be absorbed. Summing up, though growth in the Southeast on the whole may decelerate from last year, on average it is still likely to be fast enough to stay ahead of the nation, and in many areas the prospects are for pretty robust expansion.

### **Issues in the Banking Industry**

My outlook for continued expansion should be good news in general for the banking industry, whose health, as you know, tends to wax and wane with the economy. Nonetheless, we are all aware of disturbing signs of problems. A recent study at the Atlanta Fed shows bank profitability declined further in 1986, particularly among the smallest institutions. This would suggest that bank failures will probably continue in

large numbers. Last year, 138 banks failed—the highest in any single year since the Depression, and with 142 banks closed by the end of September it is clear that the pace of closings this year has not abated. Fortunately, the failures we are seeing are not having systemic effects. Many are due to the weaknesses concentrated in certain sectors, such as energy or farming, and in particular regions. There are, however, other issues with far-reaching implications such as deposit insurance, off-balance sheet activities, interstate banking, and product deregulation. In a sense these issues are all subsumed by the larger question of balance between regulation and deregulation. In some areas like interstate banking, we haven't gone far enough, yet in others we seem to need new or tighter restrictions. In the time remaining, therefore, I'd like to discuss some of the major issues involving the banking industry.

Let me start with what I believe is one of the easier issues to resolve by simply completing the movement toward deregulation that was begun a few years ago. That issue is—geographical barriers. We've come a long way toward geographical deregulation of the financial services industry and, in so doing, giving greater vent to the creative forces of market competition. Approximately 23 states have authorized, or will authorize within the next 18 months, nationwide interstate banking, and only seven states have not shown any significant movement toward either regional or nationwide interstate banking. Despite the number of states that have at least regional banking provisions, however, a hodgepodge of geographic limitations make the situation more difficult. In addition, most interstate laws now on the books prohibit de novo entry. Thus we have not yet achieved effective interstate banking, and customers are still deprived of the competitive choices in prices and services such geographical deregulation would bring. I do not deny that the experiment with regional interstate banking—one in which southeastern banks joined early on—has been a worthwhile move in the direction of breaking down barriers that are no longer viable, but we must remember that it is just

the first step in a longer journey. It is time to adopt a more systematic approach at the national level toward what I feel is the inevitable and beneficial adoption of full nationwide interstate banking, especially in view of the veritable globalization of markets—not just in the "real" economy as I noted in my remarks on the outlook but even moreso in financial markets.

While the issue of interstate banking is a relatively simple one to solve, other issues on the road to deregulation are far less tractable. We have heard much lately about the need to expand the powers allowed to banks so that they can compete effectively with unregulated intermediaries which offer banking-type services. I agree that this is a desirable goal, but in many respects it is theoretical. We cannot move quickly from a system that has been regulated and protected in such diverse ways to one that is totally unconstrained. In most other sectors of the economy, we could easily say that the strong would survive and the weak fail and so be it, but we cannot really do this in banking. The reason we cannot is that we are committed to insuring smaller deposits, and we have often acted as if we are essentially insuring all creditors of banks, save the stockholders. We must directly deal with the question of what we will and will not insure—the boundaries of the safety net—before we should permit banks to enter new areas of business. The cost of failures to the FDIC as well as to FSLIC ought to teach us this lesson.

Deposit insurance is thus the most pressing of all the issues we face. Until the recent banking act was passed, the chief concern in this area had been the weakness of the FSLIC. Passage of the act was a much needed measure. Unfortunately, the \$10.8 billion provided to bail out the fund appears far from adequate and thus makes it likely that Congress will eventually turn to the taxpayers and bankers as sources for further assistance, perhaps by proposing a merger of the FSLIC and FDIC. However, aside from

this eventuality, which I know is troubling to bankers and even to most S&Ls, deposit insurance is in need of more general reform to correct the problem economists call moral hazard. By insuring depositors, something to which we as a nation have become deeply committed, we inadvertently create incentives to bank managers to undertake excessive risks, especially when their institutions are already facing declining earnings figures. To deal with this problem, some people have proposed tying deposit premiums to risk. Although there is merit to this viewpoint, I feel we could, instead, let the markets do part of the work, perhaps by impelling uninsured depositors and holders of subordinated debt to exert more surveillance and discipline on institutions they patronize. FDIC proposals for limited payout of uninsured deposits at failed banks and for greater disclosure of banks' financial condition embody this approach. Of course, if market discipline is to prove effective, we also have to avoid bailing out shareholders and all creditors at failed institutions as has been done in the past. An additional and, in my view, preferable alternative would be risk-based capital requirements, an area where we have proposed some change. These could provide a cushion for the insurance funds and help buffer the industry from systemic risk.

Such a reform of capital requirements could also address the problem of off-balance sheet items. Because they understate the amount of risk relative to capital, the 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. Adequate capital to back up off-balance-sheet items would limit inappropriate risk taking. To be effective, however, international coordination is needed since banks around the world are placing more emphasis on these products as sources of income. The coordination between American and British regulators that led to the currently proposed guidelines on off-balance sheet items has been a welcome initiative. I would hope to see such efforts expanded to encompass other

advanced economies.

I do not pretend to know all the answers to these complex issues. I am convinced, however, of the urgency of the situation. The same international competitive forces that are playing an ever increasing role in the U.S. and southeastern economy, which I outlined at the start of my remarks today, will push many of these issues to some kind of resolution if we fail to act. The danger is that that resolution may not be the one we would have chosen. With global capital markets, for instance, institutions will simply go "offshore" to offer services prohibited to them domestically, thus evading regulations altogether and making it even harder for regulation to ensure its most basic end—the safety and soundness of the financial system.

As for the general direction in which policy makers should be moving, I'm afraid we have to beware of sweeping changes that would be categorized under a single rubric like "deregulation." The current problems faced by many institutions and even entire industries like S&Ls indicate that we proceed with caution. The real challenge to legislators and regulators in this by no means optimal environment in which we find ourselves will be to avoid falling into the traps of the past, such as waiting until problems reach crisis proportions so that we really have no options, no choices. We must also beware of focusing too much on the present and the past as we try to help institutions make a transition through the short term into more flexible organizations that are more viable for the long run.

### **Conclusion**

I began my remarks by focusing on the growing importance of international developments to the nation's and the southeastern economy. The continued moderate growth these developments promise to bring to our economy should help the banking

industry work through some of its current problems. However, over the longer term the competitive pressures, many of which are also international, faced by the industry require that solutions be found for the problems I've outlined today. These must be solutions that are not just temporary stopgaps that actually undermine the competitiveness of institutions we're trying to help but rather measures that help move us toward that elusive long run theoretical goal of more competitive financial markets.