

THE NATIONAL ECONOMIC OUTLOOK AND CURRENT ISSUES IN BANKING
Remarks by Robert P. Forrestal, President
Federal Reserve Bank of Atlanta
to the Board of Directors of the John H. Harland Company
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Good morning! I am pleased and honored to have this opportunity to meet with you directors of the Harland Company. When Bill Robinson extended the invitation to be with you this morning, he asked that I discuss the outlook for stability of the financial community along with several specific Fed-related issues--inflation, the value of the dollar, the money supply, and developments in the Fed's philosophy. Events of recent days have certainly made your interest in financial system stability and the Fed's philosophy a timely one. Let me say at the outset that the prospects for continued health in the financial community are excellent. The past week's events have tested the depth and resiliency of the markets, and they have not been found wanting. Amidst the unwelcome turbulence we were again reminded of the Fed's steady commitment to ensure that the financial system has sufficient liquidity, an example of the sturdy structures that remain in place to undergird the soundness of today's financial system. In this respect and others, the Fed's philosophy clearly has not changed. To put current events and Bill's original concerns into perspective, I feel the best approach is for me to discuss first what is a generally positive economic outlook and then to proceed to a brief overview of some issues that have the potential to affect the health and stability of the financial community.

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, however, 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 ratcheted up far more, although much of this has been reversed in recent days. 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. According to the Atlanta Fed Dollar index, the dollar has fallen 29 percent against the currencies of most of our major trading partners since its peak in February of 1985. It has not fallen nearly as much against the currencies of Canada, our major trading partner, and the newly industrializing countries of the Pacific rim, however. From February of 1985 to the end of this September, for example, the dollar was off only about 7 percent vis-a-vis the Canadian dollar and the currencies of countries like Taiwan, Korea, Hong Kong, Singapore, and Australia. I would not want to speculate on what will happen to exchange rates in the future--another of your interests. I can say, though, that the currency realignment we've already had is starting to have a positive effect on our economy. In fact, exports began picking up in real terms in the last three months of 1986 while imports flattened. Real net exports have now improved for three consecutive quarters for the first time since 1980. This seems to be passing through to our manufacturing sector, which had been so adversely affected by the dollar's earlier appreciation.

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.

Turning from GNP to prices, 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. Our September discount rate hike demonstrated our resolve to keep prices under control.

While I'm on the subject of apparent changes in Fed policy, I might as well respond to another of your interests, namely, the money supply. As you know, we measure the money supply in terms of the monetary aggregates--M1, 2, and 3. M1 is the measure containing the most liquid forms of money--cash, demand deposits, and travelers checks. Until February of this year, the Fed had set ranges for its growth to help determine policy. We stopped primarily because of the behavior of M1, which began to grow at an unprecedented pace due to the near equality of rates paid by interest-bearing checking accounts like NOW accounts and time deposits, which are included in M2.

People had less incentive to move excess money into M2 than they had when savings accounts paid higher interest. As a result, M1 swelled beyond its targets in 1985 and 1986. Thus, judgment about the appropriate growth of the aggregates has become both more difficult and more dependent on prevailing economic and market circumstances. M2 is currently running below and M3 around the bottom of their 5 1/2 to 8 1/2 percent monitoring ranges, and I feel that, depending on evidence with respect to emerging trends in other areas of economic activity, actual growth around the lower ends of those ranges may well remain appropriate. As in the case of the discount rate hike, I don't see the decision not to target M1 as a change in policy. Rather, this case reflects a change in the effectiveness of one of the gauges on which we had relied for setting policy.

The loss of that gauge--and it may be permanent given the changes taking place in the financial services industry--is unfortunate. Still, we do have other guides to policy decisions. One of these is the likely future course of the economy and prices. As I have said, my view of the economic trends remains one of cautious optimism. 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.

Stability of the Financial Services 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, 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 ^{whole segments} ~~even entire~~ ^{of the} 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 nation's economy. The continued moderate growth I foresee for business activity should help the banking industry work through some of its current problems. However, over the longer term the competitive pressures faced by the industry require that lasting 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 long run, theoretical goal of more competitive financial markets.