

**BANKING TODAY AND TOMMOROW: BALANCING THE ADVANTAGES OF
DEREGULATION WITH THE NEED FOR STRENGTHENED REGULATION**
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Good morning! I am pleased and honored to have this opportunity to meet with you people who keep the books of Atlanta's businesses in balance and your guests from the banking industry. When I agreed to talk to you about the future course of banking and financial services, and particularly the balance between regulation and deregulation, I did not, of course, realize how much financial issues would be on everyone's mind. Since the stock market crash on October 19, we've been obsessed, it seems, with real and imagined ills in our financial markets and their potential effect on the financial system and the economy. In that regard, I'd like to emphasize at the outset that the prospects for continued health in the financial community are excellent. The turbulence since mid-October has tested the depth and resiliency of the markets, and they have not been found wanting. Amidst the gyrations of prices, we were again reminded of the Fed's steady commitment to ensure that the financial system has sufficient liquidity. This reminds us of the sturdy structures that undergird the soundness of our economic institutions.

Nonetheless, the market's volatility has reminded us of the the close, albeit complex, nature of economic and financial linkages. Therefore, while events in the market have made our reading of the economy's future course more difficult, my discussion of the financial services industry now more than ever requires a sense of what the economic outlook holds to give it proper context. Therefore, I'll preface my remarks on banking this morning with a brief overview of the national outlook.

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 this year at a rate of about 3 percent and to come in a bit under that in 1988, say 2 to 2 and 1/2 percent. Unemployment has fallen from the 7 percent level, where it remained lodged most of last year, to 6 percent in October. 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, as measured by the consumer price index, should be higher than last year's very low pace. Prices will probably be 5 percent higher in 1987 and rise by a little less than that in 1988. 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. 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 the third quarter were up 7 percent.

Developments in the international sector are critical to the outlook for GNP growth also. Improvement in the foreign trade situation, which some support from consumption, will be the engine behind our moderate rate of expansion. The trade 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. First, the stock market plunge has adversely affected consumers' wealth, and it remains to be seen whether this loss will cut significantly into consumption. More fundamentally, the low savings rate and high debt-to-income ratios that resulted from very high consumer spending growth over the past few years 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 to the rest of the world some of the debt 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. First, recent stock market volatility around the globe has added an element of uncertainty that clouds the outlook for investment even though interest rates have fallen in the past three weeks. Second, by treating some aspects of investment less favorably, changes in the tax code have exacerbated the short-run effects of residential and office 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, there is considerable excess space to absorb. Even in an environment of lower mortgage rates single-family housing is likely

to remain weak a while longer. On the other hand, the fact that I look for exports to increase, which I'll discuss in just a moment, means that investment in equipment, factories, and warehouses should sustain the reasonable health we saw evidenced in the third quarter. On balance, though, 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. I am hopeful that Congress and the Administration will make a permanent reduction in the full-employment budget deficit relative to GNP in their current discussions. Progress on this front is vital to us as a nation.

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, as of late October the dollar had 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 October, for example, the dollar was off only about 6 percent vis-a-vis the Canadian dollar and 7 percent against the currencies of countries like Taiwan, Korea, Hong Kong, Singapore, and Australia. In this current, highly volatile environment I would not want to speculate on what will happen to exchange rates in the future. I can say, though, that the currency realignment we've already had has been having a positive effect on our economy. In fact, exports are up strongly. Real net exports had improved for three consecutive quarters for the first time since 1980 before reversing course slightly in the third quarter of this year, and that loss was due mainly to an increase in oil imports. This ongoing increase in net exports, exclusive of oil, 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 I mentioned in passing a moment ago, 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 a somewhat faster rate in 1987 than it did last year, over time more of that increase in output will be exported and less of it will be available for domestic use. While the current market situation renders any forecast less certain, we can at least hope that the stock market's message has been received in time for those in power to resolve their differences and embark our federal government on a lasting course of deficit reduction.

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 were all aware of disturbing signs of problems well before the stock market collapse. 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 over 150 banks closed already

this year, it is clear that the pace of closings has not abated. Fortunately, the failures we are seeing are not having systemic effects, and the events of the past three weeks have not shaken any depository institutions. There are, however, banking issues with far-reaching implications. These include 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, except the stockholders. We must deal directly with the question of what we will and will not insure--the boundaries of the safety net--before we 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. Thus, in my view, we cannot grant banks many new powers until we have devised a measure to address the moral hazard issue.

Several approaches to "fixing" deposit insurance have emerged. Some people have proposed tying deposit premiums to risk. Currently, banks' deposit insurance premiums are set at a flat percentage of their domestic deposits regardless of their risk exposure. Alternatively, some economists advocate a less regulatory approach, such as limiting deposit insurance coverage so depositors will have more incentive to enforce market discipline on banks and penalize them by moving their money when risk exposure seems excessive. A less dramatic, yet still effective way to let the markets do part of the work might be to impel 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. A third alternative, and one that I prefer, is to improve the identification and regulation of risk. In an effort to come to grips with risk, the Federal Reserve, the Bank of England, and regulators in Europe and Japan are devising new capital standards that account more accurately for banking organizations' overall risk exposure. These standards break assets into several categories based on their probability of default and assign different capital requirements to each of the categories. Changes of this nature 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 have answers to all of 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 our nation's economy and which have been a constant theme in 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 segments of the financial services industries--S&Ls, for example--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 are left with few options. 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 viable in the long run. As for the financial markets--in contrast to institutions--I think we must focus not on program trading or symbols of problems but on fundamentals like the federal budget deficit that have been causing imbalances in our economy, not for 3 weeks but for several years.

Conclusion

I began my remarks by focusing on the nation's economy. Recent behavior of financial markets has demonstrated that forecasting the future is a risky business, and that increased uncertainty applies no less to the economic outlook I've presented today. Notwithstanding this important caveat, I believe the prospects for continued economic growth are good and that this environment should help the financial services industry work through some of its current problems. The challenge that we face is to address the right problems and to do so in a way that results in solutions that enable banks and other financial intermediaries to meet the challenges of a global economy. The measures we adopt must not be just temporary stopgaps that actually undermine the competitiveness of institutions we're trying to help but rather policies that help move us toward that long run, theoretical goal of more competitive financial markets.