

**THE ECONOMIC OUTLOOK FOR THE NATION AND THE SOUTHEAST
AND ISSUES IN THE BANKING INDUSTRY
Remarks by Robert P. Forrestal, President
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to the Board of Directors of Trust Company Bank
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Good morning! I am pleased and honored to have this opportunity to meet with the Trust Company board. I have been asked to offer you my perspective on the economic situation in the nation and the Southeast and to touch on current issues in the banking industry as well. We are living in interesting times, economically speaking--probably a bit too interesting for some. Since the stock market's crash on October 19, much has been written and said about the condition of our financial markets and what they are telling us about the potential direction of the economy. We have heard predictions of disaster from some quarters, while from others we are told that the event had meaning only for overheated exchanges. Fortunately, the aftershocks of "Black Monday" seem to be leveling out now, and so we should be at a point where we can bring some balance to the discussion of the outlook for our national and regional economies. Let me say 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 capital markets, and they have not been found wanting. Amid the gyrations of prices, 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 our economic institutions.

The simultaneous turmoil in securities markets at home and abroad emphasizes a theme which is an integral part of my outlook. Internationalization of markets is, in my opinion, the most important dynamic affecting the economic picture today. We need look no further than the worldwide extent of mid-October's collapse in equity markets to realize that events in one country's finances generate virtually instantaneous responses of unprecedented proportions in all the world's financial capitals. I will begin, then, with

a review of the national outlook and an assessment of our region's prospects, which are, of course, determined in large measure by what happens in the nation as a whole. Then I shall discuss the major issues affecting the banking industry and leave a few minutes for any questions you may have.

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. Unemployment has fallen from the 7 percent level, where it remained lodged most of last year, to just below 6 percent in November. 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, is clearly above last year's very low pace. Prices will probably end up about 5 percent higher for 1987 and rise by a little less than that in 1988.

Developments in the international sector are critical to this outlook. The higher prices in this forecast are due in large part to the lifting of oil prices from very low 1986 levels but also to the rise in prices of other imports, which as of the end of the third quarter were up 7 percent. As for GNP growth, improvement in the foreign trade situation will remain the engine behind our moderate but healthy rate of expansion. The trade deficit is already shifting in our favor in real terms, although the gap between imports and exports is taking longer to narrow in current dollars. Even in nominal terms, however, the October trade deficit figure of \$14.1 billion was a welcome sign of some improvement. With this turnaround in net exports, and particularly in strong export growth, we have seen an improvement in the manufacturing sector. Industrial production is now 5 percent higher than it was last year at this time, and capacity utilization is the

highest it has been in over three years.

Consumption, while slower than in past years, may be helped by international developments. The growth in salaries associated with manufacturing's rebound--factory wages tend to be higher than those for service-sector jobs--should help bolster consumer spending. Nonetheless, consumption, which accounts for about two-thirds of GNP, 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. 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 household 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 Atlanta 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 increasing burden of debt service. The only way we can accomplish this task is by consuming less of our own increases in 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 fell in the wake of the crash. Second, by treating some aspects of investment less

favorably, changes in the tax code have exacerbated the 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 at least until the latter part of next year. On the other hand, the fact that I look for exports to increase means that investment in equipment, factories, and warehouses should be reasonably strong as domestic manufacturers boost output. Combining the two components, we come up with little change in investment. Thus, on balance it will neither retard nor push GNP growth. As for government purchases, I am gratified that Congress and the Administration have made some headway in achieving a permanent reduction in the full-employment budget deficit relative to GNP, but we will need more of this since progress on this front is vital to our economic health as a nation.

The effective stalemates in consumption, investment, and government spending lead me to pin much of my positive forecast on an improvement in net exports. I expect this improvement for two reasons. The first is the decline in the value of the dollar in foreign exchange markets. According to a dollar index developed at the Atlanta Fed, our currency has fallen 30 percent against those 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 late November, for example, the dollar was off only about 6 percent vis-a-vis the Canadian dollar and 8 percent against the currencies of countries like Taiwan, Korea, Hong Kong, and Singapore. 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 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 had improved for three consecutive quarters for the first time since 1980 before reversing course slightly in the third quarter of this year. Despite the third quarter decline, which was largely due to an increase in oil imports, exports from this country continued to show significant gains. 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 contributed to this situation. To meet our financing needs, we have been borrowing from abroad. Of course, common sense tells us 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. 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.

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. Continued stability in the energy sector is especially relevant to Louisiana and the parts of Mississippi that were adversely affected by the sharp fall in oil prices last year. Lower unemployment rates in both states are evidence of some improvement. I feel confident that they have reached bottom and are in position to begin to turn around. Agriculture, too, remains depressed but at least exhibits encouraging signs. The cotton crop is excellent this year, and prices are up. Except for feed grains and rice, total crop output is better than last year, and a combination of reduced acreage, higher yields, and stable or higher prices is expected to improve net farm revenues substantially. A few years of similar results could bring the industry back to health.

On a more immediately 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. In the first ten months of 1987 the dollar fell more sharply vis-a-vis Taiwan's currency, for example, than against the currencies of our other trading partners. I expect such 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, 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.

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 over 170 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 month and a half 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 half the states have authorized, or will authorize within the next 18 months, nationwide interstate banking, and only a handful of 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 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. Thus, in my view, we cannot grant banks many new powers until we have devised a measure to address this problem of "moral hazard".

Several basic 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, and capital adequacy standards are only loosely related to risk. We could also limit 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 would be 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. The second alternative 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 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 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 more viable for the long run. As for the financial markets--as opposed 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 6 weeks but for several years.

Conclusion

I began my remarks by focusing on the nation's economy. The continued moderate growth I foresee for business activity should help the financial services 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 solutions must not be 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.