THE INTERNATIONAL ECONOMIC OUTLOOK FOR 1991

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Good afternoon! I am pleased and honored to have another opportunity to speak to the Georgia Bankers Association. I have been asked to give you my outlook for the international economy. Obviously, our thoughts today are dominated by the grim situation in the Middle East. Nonetheless, we can look ahead to other international developments that help renew our hopes of a global order based on commerce rather than armed conflict. Among these, I count the economic integration of Europe in 1992, and I would like to talk about a few aspects of that link in the expanding global market this afternoon. I would also like to make a few observations about how Europe 1992 might affect banking in this country. First, however, let me give you my outlook for the international economy.

International Overview and Outlook for the U.S. Economy

In considering prospects for growth in 1991, I must emphasize that any forecast depends on the price of oil. Regardless of how long the conflict in the Middle East lasts, the invasion of Kuwait has already brought us a significant adverse supply shock which reduces this country's ability to produce a given level of output at a given price. This fact has been evident in the weaker economic performance of recent months and has led to forecasts for slower growth in the year ahead. Lately we have seen a drop in oil prices for several reasons. The fundamentals, especially greatly increased output from oil producers other than Iraq and Kuwait, suggest that current supply shortages are being met for the most part. Moreover, the market appears not to expect hostilities to interrupt supply. In the long run, however, there is a limit to the decline in prices because non-OPEC production is falling off, and growth in demand has been only temporarily slowed by the price shock. Thus, the situation in the Middle East continues to compound the uncertainty in the economic outlook for the year ahead.

With this caution in mind, I believe growth worldwide will moderate on average in the year ahead, although Japan and Western Europe should still make relatively strong showings. I expect the U.S. economy to remain weak for a while, but by the second half a moderate rebound should begin. Great Britain and Canada are likely to remain in recessions at least through the first part of the year. Overall, economic growth should increase about 2 percent in the industrialized economies. Unemployment will probably remain relatively high in Europe, though below the double digit rates of the mid-1980s, and low in Japan--probably just over 2 percent. Price pressures in Japan and most West European countries should peak by spring and then decline moderately, although German inflation could continue to rise throughout the year.

Let me describe my thoughts on the U.S. outlook for 1991 in a bit more detail. I look for real gross national product to average about 1/2 percent for the year. The contraction we saw in the final quarter of 1990 will probably continue for a while and retard overall growth for the year in spite of a pickup I expect later on. Since employment lags behind GNP, I think joblessness will be slightly above 6 1/2 percent at year's end. I look for inflation to abate, however, and drop back to about 4 percent as an annual average, compared with last year's increase of just under 5 1/2 percent.

I feel that the strongest portions of the economy will be services consumption and exports. The service sector, which represents half of all personal consumption expenditures, will certainly enjoy respectable growth. Net exports should also remain a source of strength as Japan and several West European trading partners experience relatively strong expansion. In addition, business inventories are extremely lean, and adjustments to inventories will therefore not aggravate any downturn by nearly as much as at similar points in past cycles. Underlying this anticipated growth are the Fed's earlier and recent easing moves, which should make themselves felt over time and provide impetus to growth.

Weaker sectors include construction, business investment, and consumers' purchases of durable goods. Construction suffers from lingering excess supplies due to past overbuilding as well as hesitancy among many lenders to finance new projects. The population shift associated with the aging of the population should continue dampening the demand for first-time home purchases. Thus, the construction industry is not likely to provide support to growth in the year ahead. I believe, however, that the downturn in construction is probably near the bottom and that the industry is not as likely to exert as much of a drag in 1991. Consumption of durable and nondurable goods should remain in a cyclical downturn this year. In addition to this slump in consumer demand, many in the business sector are encountering tighter lending standards at their banks. Thus, it does not look as if capital spending by businesses on new plant, offices, or equipment will lend support to the economy.

The Gulf war's impact will probably make fiscal policy a positive factor in this year's economy. However, the degree of stimulus provided by government spending will depend upon the length and intensity of fighting in the Persian Gulf--neither of which can be predicted now.

Outlook for Other Industrialized Countries

Moving to other industrialized countries, in Germany the financial implications of unification between the eastern and western parts of the country will almost surely continue to dominate the economic picture. Concerns over further government borrowing needed to achieve a united German state led to tighter monetary policy in the early part of this year. Although growth in western Germany could average as much as 3 percent for the year, the drag of the eastern economy might bring the country's combined economic performance down to the 2 percent range. Unemployment, too, will be unevenly distributed between the two parts of Germany. In the west, joblessness should remain about where it has been, but in eastern Germany, the number of unemployed there should rise significantly. I expect inflation at the consumer level to continue rising toward the 4 percent level.

Growth in Italy and France could hover at or slightly below 2 1/2 percent, somewhat off from their performances last year. Inflation in Italy is likely to be double France's rate of 3 1/2 percent, while unemployment in both countries could remain above EC averages. Britain and Canada are entering the new year in recession, and, the downturns in both countries may stretch into the third quarter. Whereas a slowing economy should reduce the U.K. inflation rate substantially, prices in Canada are likely to rise on average, though mainly as a result of the "goods and sales tax" that went into effect in January.

After averaging about 5 1/2 percent in 1990, Japan's growth rate should drop back closer to 3 1/2 percent this year--still enviable by international standards. Relatively slower overseas growth will probably cut into the country's export business, though buoyant domestic demand should compensate for this loss to some extent. Some potential clouds loom on the horizon for Japan, however. Last year's plunge in equity markets has hurt the prospects for business investment there, and Japanese banks, which have experienced losses in capital as a result of the crash, may now face declining real estate values as well. Thus, Japan's longer term outlook may be somewhat less optimistic.

In sum, the international outlook is for continued, albeit more moderate growth as relatively strong performance in

Western Europe and the Pacific Rim nations balance more sluggish economies in the United States, Great Britain, and Canada. I look for the latter countries to emerge from their doldrums later in the year, however.

The Movement toward European Economic Integration in 1992

As we consider the world's outlook, international trade stands out as a pivotal factor driving economic growth. One important link in the global commercial network is the lowering of trade barriers in Europe in 1992. I would like to spend just a few minutes on some key aspects of Europe's economic restructuring, namely the end to non-tariff barriers among European countries and the prospects for monetary union. Most tariffs and quotas on goods and services were removed in fairly short order after the 1957 Treaty of Rome. However, in place of these overt forms of protectionism a broad variety of non-tariff barriers arose in the 1970s and early 1980s as loopholes to protect powerful industries in individual countries. These new barriers included differences in product standards across countries, local content and domestic origin rules, and controls and taxes imposed at national borders. Amendments to the Treaty of Rome adopted in 1985 deal with these non-tariff barriers through the principle of "mutual recognition." Under this principle, by the end of 1992 each nation must freely admit products meeting the legal standards of other member states even if its own standards are different. There have been estimates of a considerable boost in the EC's gross domestic product when such provisions take effect, and, indeed, substantial savings in cost should occur over time.

The creation of a single market in Europe could also work to the advantage of many U.S. firms, particularly those accustomed to producing for and selling to a nationwide market here. Their experience might give them a competitive advantage in a European market that will have more consumers than our own. The story in banking is a bit different. Current product and geographic restrictions in this country prevent U.S. banks from expanding their operations in scale and scope to match the potential growth of their European counterparts. Most foreign banks already have considerably greater latitude in the types of activities in which they can engage than do ours. Banks in West Germany, for example, can hold equity positions in private companies while banks here cannot even underwrite equity issues. Moreover, it appears that EC banks will soon be able to cross international boundaries in Europe with much greater ease than U.S. banks can cross state boundaries here.

These disparities could put both our banks and our businesses at a disadvantage in the post-1992 EC market as well as in other parts of the world. U.S. companies doing business abroad are likely to seek banks diverse enough to provide a complete range of support services. The same, of course, will be true of European firms, which are already accustomed to the convenience of "one-stop shopping." This situation may appear to be a matter of concern only to big banks, but the scope of its adverse impact is much broader.

Small and medium-sized firms in the United States may be compromised in their efforts to penetrate the EC because their financial intermediaries cannot provide the same variety of services that their European competitors can obtain through their banks. Banks would obviously suffer the cost of lost opportunities under such circumstances.

I will have more to say about U.S. banking reform in a moment, but let me first touch on the possibility of eventual monetary union in Europe. A single European currency is probably still years away, but prospects began looking brighter at the end of last year. Britain's entry into the EC exchange rate mechanism (ERM) has moved that nation somewhat closer to accepting the principle of monetary union. Over time, such a single European currency should become increasingly attractive. Under the present ERM, currencies are allowed to fluctuate within bands of 2 to 6 percent, and swings of this nature still carry considerable uncertainty for those making business decisions. To take the step toward monetary union, though, European nations would have to cede a good deal of their economic sovereignty. For example, they would have to bring inflation rates more into line to avoid exacerbating price discrepancies among similar products from different countries. There is an interesting test of the ERM going on at the moment. While the Germans have tightened monetary policy recently, other EC countries are feeling pressures to ease. The exchange rate mechanism nevertheless implies that all of them should have parallel monetary policies, raising the question of whether revaluation will be necessary at some point rather soon.

However, resolution of the monetary union issue is not essential for achieving the liberalized trading environment we anticipate in 1992. Indeed, it might be accomplished more easily a bit later, as a logical consequence of free trade in Europe. Later in the 1990s, discussion may well turn to the formation of a European central bank as an element of final monetary union. At that time, the U.S. Federal Reserve System could well serve as a model. The central banks of individual countries, after the fashion of the Atlanta Fed and other District Reserve Banks in our system, would ensure that grass-roots concerns are not overlooked in the formulation of monetary policy for Europe as a whole.

Potential Impact of Europe 1992 on U.S. Banks

Before concluding, let me say a few words about what potential effects banks here might experience as a result of Europe 1992. First, I think it is important to understand that changes in Europe are not likely to have any great impact on U.S. banking in general in the short run. For one thing, many U.S. banks have been scaling back their European presence recently as part of their effort to cut costs. There is a great deal more consolidation that will have to occur in the industry over the next several years, and that process does not seem to favor renewed expansion into foreign markets. Meanwhile, European banks' interest in the U.S. market could diminish to some extent as they concentrate more on consolidating their positions throughout the EC. I might also add that they may become somewhat more occupied with opportunities that could slowly emerge in Eastern Europe over time. And, European banks might be discouraged from increasing their presence here until the direction of banking reform is more apparent.

Over the longer run, global market dynamics including those emanating from Europe, stand to have a profound influence on our financial services system. Primarily, they are a powerful added incentive for restructuring our banking system. Of course, domestic considerations are already prodding us toward change, and, in that regard, I was pleased to see the Treasury Department's proposals issued two weeks ago. I am hopeful that document will bring greater focus to the discussion of industry reform and, ultimately, action on improving the industry's competitiveness. In my view, we must strengthen our banking system in four fundamental ways. First, deposit insurance protection must be well defined and strictly limited in scope. Deposit insurance has allowed us to take the safety of our personal transaction balances for granted, and this has served well to prevent bank runs on solvent institutions. However, the present system has frequently protected far more than just individual accounts and thus has inadvertently created incentives for excessive risk-taking. These incentives must be eliminated.

Second, increased incentives for prudent management need to be created. Higher capital levels are a good start, but this cushion could be increased. Other measures to enhance market discipline might also be added. I favor greater emphasis on noninsured debt instruments as a means of accomplishing this. Third, we need a structural change in regulatory oversight capable of forcing institutions to take immediate steps, including liquidation when necessary, if their capital ratios fall below established thresholds. Measures of these kinds should foster prompt corrective action and minimize the costs of problems, including the collapse and liquidation of even the largest banks. Fourth, after bolstering banks' capital and reducing the deposit insurance subsidy, we should allow a general expansion of bank powers. If policymakers can address this range of concerns, I believe U.S. banks will be better suited to handle future cyclical swings in our own economy as well as the competition posed by institutions in the European Community and other parts of the expanding global market.

Conclusion

In conclusion, I look for relatively good performance from the international economy in 1991 even though the United States is not likely to be one of the driving forces in world growth, at least in the first half of the year. Instead, I expect Western Europe and the Pacific Rim nations to take the lead. Meanwhile, until the crisis in the Persian Gulf is resolved, we must look beyond present uncertainties to an international economic order that should help us avoid such unsettling episodes in the future. European Community market unification in 1992 is one step toward that eventuality. One of our chief tasks in this country is to condition our banking system for the realities of a global market. I hope that you Georgia bankers will continue expressing your opinions on the best ways to do this to our representatives in Congress. The future is closing in on us,

and we can no longer afford to delay preparing ourselves to meet its challenges.