

# **OUTLOOK FOR THE NATIONAL ECONOMY AND THE BANKING INDUSTRY**

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In the letter Fred Millsaps wrote inviting me to speak to you this morning, he explained that your group spends a good deal of time looking at state government. He wrote: "The legislature is now in session, and we all hope for miracles, which, of course, are only handed out by the Federal Reserve." Now, I do not claim to be a miracle worker, nor have I ever heard Alan Greenspan or the other members of the Federal Open Market Committee claim that distinction. But I do see some cause for optimism in the short term for the economy, the banking industry, and for those concerned about the availability of credit, which Fred indicated was another leading concern of this group. I must temper this observation, though, with a more sobering view of the long term as I give you my economic outlook for 1992 and beyond.

## **Economic Outlook**

Let me begin with the outlook for this year. I believe that we should see more encouraging signs very soon largely in response to a series of monetary policy moves over the past year or two. Retail sales and housing starts have been increasing recently, and I look for consumer spending to continue to increase slowly but steadily. Overall for 1992, however, due to the slow start in this first quarter, the economy will grow at a moderate pace of around 1 1/2 percent on average. This at least is an improvement over the contraction in our growth last year. Since employment lags behind gross domestic product (GDP) and many businesses are

consolidating, I think the jobless rate will remain pretty much unchanged from the average last year of 6.7 percent. Price pressures look more moderate than they have in some time, and the consumer price index (CPI) should increase 3 percent or a bit more as an annual average in 1992.

Generally speaking, the pace of business activity will accelerate gradually as current balance sheet problems are worked through and more household and corporate income becomes available for spending. Of course, progress will not be even across the economy. The forces bolstering growth should be exports and consumer spending, particularly on services and, to some extent, nondurable goods. In addition, later in the year, we should begin to see some improvement in capital spending by businesses. Net exports should continue to provide support, especially to manufacturing, but the pace of expansion will be slower than in the last few years. The interest rate declines that have taken place should provide a boost to consumer spending through both lower rates for new credit purchases and increased discretionary income resulting from refinanced mortgages. Nonetheless, spending growth will be quite modest compared to previous recovery and expansion periods. Even with lower interest rates, consumer spending is still constrained by high levels of household debt and the weak appreciation of housing--the principal asset of consumers.

I am sure that you are all familiar with the weaknesses in the economy. The construction industry suffers from lingering excess supplies due to past overbuilding as well as appropriate hesitancy among many lenders to finance new projects. Demographics are also contributing to

the sluggish housing market. The aging of the population means that there are not as many first-time home buyers as there were when we came out of the last recession in 1982. Besides the adverse demographics, we had eight years of expansion in which housing demand was able to be satisfied. That means very little pent-up demand developed during the recession. However, residential construction did pick up last spring and may show further improvement in the months ahead. Although there are some positive signs in the single-family market, it does not seem likely that a housing rebound will contribute as much to the recovery as it typically has in the past. Office building and other commercial construction will probably continue to decline for another year or more, though the rate of decline should diminish next year. Overall, though, construction will be less of a drag on growth in 1992.

In addition to lingering weaknesses in construction, consumer demand for durable goods remains poor. Aside from the slow pace of income growth, demographics are again a major factor. Fewer new households translate into fewer purchases of new household appliances, for example. Weakness in construction exacerbates this pattern, since expenditures for furniture and other durable goods tend to rise with growth in family formation and home sales.

### **Resurgence in the Banking Industry**

Now let me turn to more of the optimistic news I mentioned at the outset of my remarks. As you all know, the banking industry has been in the throes of a credit crunch for at least two years now. The good news is that this problem should begin to abate. The root cause of the credit crunch was the excessive real estate construction that took place in the 1980s, and, more

fundamentally, tax policies enacted early in the decade that spurred such development. When legislators recognized the serious imbalances between supply and demand that were developing, they wisely passed the Tax Reform Act of 1986. In its wake, a painful transition began, one that engulfed not only the real estate industry but others as well, including banks and their small- to medium-sized business borrowers.

Over the past two years or so, though, the Fed has taken a variety of significant actions to mitigate the credit crunch. These included several monetary policy moves, ranging from accommodative open market operations and a number of cuts in the discount rate to reductions in reserve requirements. In addition to these monetary policy moves, the Fed, along with other supervisory agencies, took several important steps on the regulatory side to establish clearer communications between bankers and their examiners. These were designed to clarify supervisory policies, particularly in regard to problem loans and concentrations of real estate loans. This change is significant because such communications have not always been optimal.

All of these actions should help to ease tightness in credit markets and improve communications between regulators and banks on credit standards. Moreover, as the economy improves, the excess real estate inventory will eventually be drawn down. Already, the loan portfolios of banks are beginning to show some improvement. In turn, the balance sheets of banks are strengthening, and as a result the stock market is showing renewed interest in bank stocks. These developments mean that it should become easier for banks to offer credit. At the same time, it is clear to me that banks will not be going back to the easy standards of the 1980s,

where many markets are saturated. In other words, there will be more international competition for credit, and so it may be harder for U.S. companies to compete for credit.

Given the resurgence of protectionism we have seen in regard to trade, I would not be surprised to see some analogous proposals put forth if foreign investment in the United States begins to decline significantly. These could involve subsidies or restrictions on capital outflows. To prepare for and prevent such a scenario, I think we must refocus tax and spending policies to increase U.S. productivity. Only faster productivity growth can enhance our competitive position in the long run. There are many steps that need to be taken to attain this goal--better education, rebuilt infrastructure, and, of course, appropriate spending on one of the most fundamental forms of human capital investment--health care. However, the most critical step in this direction is reducing the large federal budget deficit. Doing so will free more of our savings for all kinds of productivity-enhancing investment.

## **Conclusion**

In conclusion, I feel confident that both the economy and the banking industry are heading toward more solid footing. In the short term, these circumstances should result in better credit availability for businesses. In the long term, there are some clouds on the horizon, namely, banking industry consolidation and global competition. These need not augur unabated gloom, however. Banking industry reforms, such as further product deregulation as well as full interstate banking and branching, should work to strengthen the industry and make banks better able to extend credit. Likewise, prudent fiscal policies--particularly reduction of the federal

budget deficit--would better enable U.S. businesses to increase their productivity and to compete in what has become a global financial marketplace. With business leaders like yourselves addressing these issues, I remain optimistic about the long-run outlook.