Outlook for the U.S. Economy and the Banking Industry
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Governor's First Annual Bankers CEO Conference

May 22, 1992

I. Outlook for the Nation

A. Overall Outlook

1. GDP - 2% - a bit higher than earlier expected
2. Jobless rate - 7.0% on average, though by quarter 4 should be back down to level at end of 1991 -- ca. 6.8%
3. CPI -- around 3%

B. Recent data suggest a genuine recovery is under way

1. Progress in alleviating imbalances has been made over past 12 months
2. Consumer and business attitudes have improved
3. Pent-up demand has developed over time

C. Strengths in the economy's outlook

1. Exports
   a. Manufacturing is being boosted by export demand
   b. Real export growth will continue to outpace overall GDP growth
   c. Latin America and Middle East are strong sources of demand, taking up slack in sluggish European economies
2. Consumer spending
   a. Spending on services continue to grow
   b. Pick up in durables purchases stronger than anticipated

3. Housing -- This is behind some of improvement in demand for durable goods
    a. Improving conditions in resale markets for single-family housing
    b. In turn, people are buying more household items like carpets and furniture

D. Weaknesses in the economy's outlook
    1. Commercial and Multifamily Real Estate construction
        a. Problems with past overbuilding
        b. Single-family on an upswing, but not apartments and condos
        c. Office building and commercial will still decline for another year
    2. Durable Goods
        a. Slow prospects for other capital spending by businesses
        b. Capacity utilization low and modest growth unlikely to put pressure on this during 1992

Resurgence in the Banking Industry

Let me now turn to a topic more directly relevant to your conference--the outlook for the banking industry. 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. More fundamentally, of course, tax policies enacted early in the decade, along with the high inflation of the 1970s, spurred such development. The Fed's sustained anti-inflationary policy of the 1980s made real estate investment less significant as a hedge against rising prices, although many investors apparently donated the Fed's commitment to this course. Meanwhile, Congress recognized the imbalances between supply and demand that were developing and 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, nor should they. Thus, while the short-term outlook for the economy and the financial system are much brighter than they have been for a good while, there are some sobering prospects for the 1990s.

Long-term View of the Banking Industry

One of these is the change still pending in the financial services industry. Both the difficult and fascinating aspect about the banking industry is that it is in the midst of tremendous changes as it tries to transform itself from a heavily regulated industry to one that has more freedom to compete with nonbanks that are not regulated. The consolidation we have seen lately in the industry results from too much capacity in the banking segment. As I see it, the main reason behind this overcapacity has been deposit insurance.

Although deposit insurance has helped to shield the industry from systemic bank runs and has provided security for small depositors, it has also served as an implicit subsidy. This has made it attractive to open a bank in an already crowded banking system. As a result, the United States now has too many banking institutions vying for too few sound loans, reducing profitability to very low levels. While I believe it is socially desirable to keep deposit insurance, it is equally important, in my opinion, to reduce the deposit insurance subsidy. Unfortunately, lawmakers seem unable to come to grips with this underlying defect in the banking industry, although the bill passed by Congress last year did, to some extent, reduce the safety net for the industry. The logical result of the consolidation that should follow a reduction in the safety net may be, of course, that at the margin, credit will be somewhat tighter. This means that, as consolidation proceeds, firms reliant on banks as intermediaries may be particularly affected. However, that result can be avoided if the consolidation that is taking place is accompanied by further legislative reform, which would enable banks to compete with the nonbanks that have made such inroads into their customer base by offering bank-like services. Specifically, I think banks should be able to deal in insurance, securities, and mutual funds. This reform should help banks diversify their activities and thus strengthen the industry, in turn making it easier for banks to extend credit.

It would also be desirable to allow nationwide interstate banking and branching, which would promote more competition, something that is always good for customers. Small and medium-sized businesses could benefit from such an arrangement, because they would be able to look for credit from banks outside of the local community. Increased competition should also encourage banks to offer more services.

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, 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. With business leaders like that gathered here today to discuss these issues, I remain optimistic about the long-run outlook.