

An Overview of Banking, and the U.S. and Texas Economies

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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It is a pleasure to be here today on the occasion of the centennial celebration of your long and distinguished record of service to the Texas banking industry.

The Dallas Fed greatly appreciates the job that the state's bank examiners do. Research by our economists has shown that examiners play an important role in identifying hidden banking problems and ensuring they are properly reported. Stopping illegal activities, reviewing internal controls and evaluating risk-management processes are critical for maintaining a sound banking system. Perhaps your finest hour came in the state's banking crisis of the 1980s, when examiners did yeomen's work in digging the industry out of that awful mess and helped restore dignity and public confidence in Texas banks.

Examiners cover every nook and cranny of this vast state. Life on the road can be rough. The old-timers here probably remember when examiners went out for weeks at a stretch and did three or four jobs before returning home. That meant lugging around heavy examination manuals, adding machines and manual typewriters. And no examiner risked forgetting carbon paper and extra ribbons, items hard to come by in small Texas towns.

State examiners used to drive big white cars with exempt license plates and the official seal on the side. Four examiners shared one car, and the low man on the totem pole took charge of maintenance. That meant keeping the car clean, getting it serviced, buying new tires when needed and, most onerous of all, keeping the mileage books on a weekly basis. Those legendary cars were spotted in some unusual places ... like on the beaches of South Texas. I understand that if you went to a club after work, you were under orders to try to park the state car *behind* the building, not directly in front of it.

Accommodations were rudimentary by today's standards. The best motel in Pecos, for example, was some 50 yards downwind of the zoo. The motel in Matador did not have an ice machine, but examiners learned that if you went around to the owner's apartment, he would take a tray out of his freezer for you.

The Western Sky Motel in Clarendon was famous for towels you could see through when held up to the light. And if you wanted to call long distance at night, you had to find a pay phone because the switchboard closed when the operator left at 5:30.

In Big Sandy, the examiners always took up residence at Miss Annie's Bed and Breakfast. The proprietors made the shortest examiner take the sleeping loft in the attic because your head hit the ceiling whenever you sat up in bed.

Women examiners were not expected to go out to Sanderson in West Texas because the motel there did not have locks on the doors. Their male colleagues who made the trip claimed they had to shoo goats and chickens out of their rooms in the evenings. But it was not all bad. The motel was so tightly wedged between Highway 285 and the Southern Pacific freight line that the beds would vibrate all night for free.

Back then, the assistant-in-charge was the real workhorse of the examination team, having the important job of booking a hotel that had a happy hour with free hors d'oeuvres.... Well, I guess some things really have not changed all that much.

Dual Banking System

Recalling old times reminds us that America's dual banking system dates back to the National Bank Act of 1864, which gave the country national banks alongside existing state-chartered banks.

Texas had to wait a bit longer for a dual banking system. Article 7, Section 30 of the 1845 state constitution specified that "*no corporate body shall hereafter be created, renewed or extended with banking or discounting privileges.*" This provision remained in the 1876 constitution, so for decades Texans had access only to nationally chartered banks and private banks.

It was not until a constitutional amendment was approved in November 1904 that state banks came into existence in Texas. The amendment not only authorized the incorporation of state banks and savings and loans, but also provided for "a system of state supervision, regulation and control of such bodies which will adequately protect and secure the depositors and creditors thereof."

W.J. Clay, the first superintendent of banking, seemed to wonder what took so long. In one of his reports, he wrote: "*It is very remarkable that a country such as Texas, in extent and variety of interests unapproachable and in a class alone, should not for a period of nearly seventy years, have provided a banking system under control of its own laws and designed to meet its own peculiar demands. In fact, she is the last one of the great States to adopt this system into its financial economy.*"

The Legislature then passed the Texas State Bank Law on Aug. 14, 1905, and thus the Texas Department of Banking now celebrates 100 years of service to the state's banking community and citizens.

The business got going rather quickly. The first Biennial Report of the Superintendent of Banking, dated Dec. 21, 1906, tells us the state chartered 135 banks, 21 bank and trust companies, and one savings bank. At the time, Texas had about 450 national banks and 190 private banks.

Today, the state-chartered banking system is competitive and strong. As of June 30, 330 of the 637 Texas banks had state charters. In the past three years, 13 of the 23 newly chartered commercial banks—or 57 percent—chose state charters.

The dual banking system provides our financial system with strength and flexibility. This system is deeply ingrained in our culture and reflects the American preference for decentralization of authority. As Chairman Greenspan has said, banks' freedom to choose their regulator is a key protection from the potential for unreasonable regulatory behavior. The doctrine of choice creates a healthy dynamic among regulators.

Under the dual banking system, state-chartered banks have fostered many innovations, resulting in an ever-widening array of products and services. State banks pioneered demand deposits, and a state-chartered bank introduced the NOW account. The first banks to offer variable-rate mortgages and home-equity loans came under state regulation. The states have been innovators in consumer protection as well.

The dual structure requires cooperation by state and federal authorities. The Texas Banking Department and the Dallas Fed have a long history of working well together, routinely relying on each other's efforts in administering the Alternate Examination Program, a service in place since 1981. The Dallas Fed provides access to training events offered by the Federal Financial Institutions Examination Council and Federal Reserve System, which gives examiners at both agencies a common learning experience. There is mutual, professional respect among our examiners.

I am here today to salute you and tell you that the Federal Reserve looks forward to continuing a partnership that has helped ensure consistent, effective and high-quality supervision.

The Banking Industry Today

America's economy stands head and shoulders above the rest of the world. One of its strengths has been a dynamic and competitive banking system. The industry continues to exhibit strength. Asset growth is strong at more than 8 percent for the past year. The noncurrent loan rate is below 1 percent. In the second quarter, U.S. banks recorded a return on assets of 1.3 percent, evidence that capital positions are healthy. In fact, for the past 12 years, banks have earned a return of greater than 1 percent. This is unprecedented in the modern era, which began with the end of the Great Depression.

The Fed began its recent tightening moves in the middle of last year, and we have been hearing about such things as yield curve conundrums and froth in housing markets. A lot of people were probably concerned about the impact of rising interest rates on banks, but so far banks continue to do well indeed.

Banks' net interest margins have been declining, but that has been the case since the early 1990s. The current net interest margin of about 3.6 percent is almost three-quarters of a point lower than what we saw a decade ago.

Non-interest income has taken up the slack as banks increasingly rely on this source of revenue to boost profits. Ten years ago, non-interest income amounted to 2 percent of average bank assets. At the end of last year, it had risen to 2.4 percent.

Gains in non-interest income have not come from service charges on accounts. Revenue from this source amounted to 0.4 percent of average assets at the end of last year, the same as it was 10 years ago. Nor have they come from trading revenue or fiduciary activities, which also held steady over the past decade. The source of rising non-interest income can be found instead in servicing fees, securitization, gains on loan sales and ATM fees. Income from these sources has risen to 1.5 percent of average assets, compared with 1.2 percent in 1994.

Looking at the balance sheets, banks have recorded strong growth in commercial and industrial loans. Second-quarter data show business loans up 12 percent from year-earlier levels. That is good news, especially when we consider that business loans at U.S. banks actually declined in 2001, 2002 and again in 2003. And the climate for such lending by banks continues to look favorable.

Risk spreads spiked last spring, coincident with news of General Motors' difficulties, but they have narrowed recently. The net financing gap at U.S. corporations—the difference between capital expenditures and internally generated funds—hit a low point in the middle of last year but rose in the fourth quarter and remained positive in the first quarter. As the gap widened, net corporate bond issues were off fairly sharply in the first quarter, indicating firms are relying more on the commercial paper market and bank loans to meet their outside funding needs.

Results from the Federal Reserve's most recent Senior Loan Officer Opinion Survey also indicate strength in banks' business lending. On net, 40 percent of respondents indicated stronger demand for commercial and industrial loans at firms with annual sales greater than \$50 million, while 35 percent reported stronger demand by small firms. A net 17 percent of banks reported they had eased lending standards on their commercial and industrial loans to large firms. Eleven percent eased them for small companies. Banks attributed the changes to aggressive competition from other lenders, increased tolerance of risk, and a more favorable economic outlook. These factors also led a net 46 percent of the respondents to indicate they have narrowed spreads between their cost of funds and rates on commercial and industrial loans to large firms. On net, a third narrowed spreads to small firms.

Turning to the consumer side, the main story line seems to be mortgage lending. Banks' residential loans increased 3.6 percent in the second quarter. For the past 12 months, they have risen more than 14 percent.

The array of innovative ways in which people can now obtain mortgages has received fairly extensive publicity. In particular, it has been suggested that borrowers, emboldened by rising house prices, are turning to nontraditional mortgages to qualify for increasingly expensive homes, setting the stage for potential repayment problems in the future.

In this regard, the Federal Reserve surveyed banks on the importance of nontraditional mortgage products, such as loans with multiple payment options and interest-only mortgages. About 70 percent of those surveyed reported that such innovative products constituted less than 15 percent of the mortgages on their books. Interestingly, more than half the banks indicated that they were about as likely, or somewhat more likely, to securitize these products than traditional mortgage products. It would appear that whatever new risks may be associated with the increasing use of nontraditional mortgages are being dispersed across financial institutions and investors.

Speculative activity was also a part of the loan-officer survey. Over the past 12 months, more than three-fourths of the banks said that less than 10 percent of residential mortgage loans they originated went to the purchase of a second home or investment properties. At the same time, delinquency rates provide little reason for concern. They have tended to be lowest in high-appreciation states such as California, where nontraditional mortgage lending is commonplace.

Even so, we should not be overly sanguine about the housing boom and associated trends in

home-mortgage lending. The delinquency data do little to allay concerns over the potential for increased mortgage risk. Given the rapid increases in house prices in some markets, one would not expect to find many signs of credit difficulties because financially strapped borrowers could, logic tells us, simply sell their homes for a profit, rather than default on their loans. But markets can sometimes stand logic on its head, so we must remain vigilant in adhering to prudent lending standards. Rising house prices would tend to conceal any added risks accompanying them. We will continue to keep a watchful eye for the potential dangers of stagnant or falling home prices in the future, combined with the potential for increases in mortgage payments relative to income.

National Economy: Clouded by Katrina

When I accepted your invitation to speak, we had no idea that we'd come together today in the aftermath of the worst natural disaster in modern American history. We have all seen the horrific images and heard the heartrending stories of the havoc wreaked by Hurricane Katrina in Louisiana, Mississippi and Alabama. The region's economy has taken a massive hit, with psychological and economic ripples spreading to the rest of the nation.

Before Katrina, the national economy was in pretty good shape, with most signs pointing to fairly strong growth. GDP had expanded by 3 percent or better for nine straight quarters. Aside from manufacturing, the job situation also looked bright. In August, nonfarm payroll employment totaled 135 million, up nearly 2 percent from a year earlier. The unemployment rate was 4.9 percent, the first reading under 5 percent in three years. Despite rising prices for oil, natural gas and other energy supplies, inflation remained relatively tame. And many companies ran up against constraints on their pricing power—the ability of companies to pass on higher costs for energy and other inputs to clients and consumers. Over the past year, the increase in the personal consumption expenditure index was 2.5 percent; excluding the volatile food and energy components, it was up 2 percent.

How does Katrina alter the outlook? The truth is, we do not really know. Two weeks after the hurricane, the economic repercussions are still sorting themselves out. We have only limited experience in seeing how a large, flexible and globalized economy like the United States' responds to massive disasters.

You might recall that a powerful earthquake struck Kobe, Japan's second largest port, in January 1995, causing \$110 billion in damage to a city that handled 30 percent of the nation's trade. In addition to killing 5,500 and leaving 300,000 homeless, the quake destroyed 75,000 buildings and damaged another 200,000. It took two years to rebuild. The impact on the Japanese GDP, however, wasn't all that big. Despite having a major port out of commission, Japan's growth rate picked up as the year went on—going from 1.4 percent in the first quarter to 2.7 percent in the second and 4.6 percent in the third.

Every natural disaster is unique, and no two countries are the same. Japan's economy in 1995 was nowhere near as dynamic and flexible as ours is today. When it comes to Katrina and the U.S. economy, my inclination is to read, listen and watch and not rush to judgment about how the disaster will impact the economy or how monetary policy ought to respond. The hurricane's damages, as we all know, were significant in absolute terms—estimated at up to \$200 billion. We've all seen television footage of thousands of destroyed and damaged buildings. Up close, it

looks overwhelming. But it is important to bear in mind that Katrina's estimated physical losses amount to only a third of a percentage point of national wealth.

We have a huge economy—with nearly \$40 trillion in wealth, production of \$12 trillion a year and employment of 134 million workers. While Katrina's damage to Louisiana, Mississippi and Alabama is massive, the first-tier macroeconomic hit to the overall economy will be less so. We have all heard some projections for Katrina's impact on GDP and unemployment, but I hesitate to endorse any numbers. Early estimates are notoriously unreliable, and the media tend to highlight the most extreme. What's more, we tend to underestimate the inventiveness and cleverness of people and markets to respond to adversity.

It is clear, however, that a period of price volatility cannot be avoided for energy and other commodities processed, stored and transported along the Gulf Coast and the mighty Mississippi. The headlines have been full of news about gasoline climbing above \$3 a gallon, although crude oil prices have already receded from their peaks. The massive effort to rebuild the Gulf Coast will create additional demand for lumber, steel, cement and other building materials. With so many prices in flux, our inflation measures will be tricky to read over the coming months.

While uncertainty surrounds Katrina's effects on economic growth and core inflation, one thing is clear: Congress and the executive branch are acting swiftly to provide emergency funding for the affected areas. So far, the federal government has authorized more than \$62 billion for recovery efforts. I have asked my staff to carefully monitor this spending. Obviously, the political authorities, not the Federal Reserve, have the power of the purse. I pray they act wisely. With the nation's already large fiscal deficits, I personally believe it would be ill-advised for the Fed to monetize any fiscal profligacy.

Among the American economy's strengths are its size, diversity, interconnections and resiliency. I fully expect the economy to rebound from this disaster—as it did after the Sept. 11, 2001, terrorist attacks. And the Northridge, California, earthquake in 1994. And Hurricane Andrew in Florida in 1992. It will take time, of course, and we can never fully repair the damage done to individuals and families. Long ago, Thucydides might have anticipated the American spirit when he wrote: "We should remember that one man is much the same as another, and that he is best who is trained in the severest school." We Americans rise to overcome adversity and are at our finest when confronted with the severest challenges.

Texas' Economy: Doing Well

Texas was spared Katrina's destruction, if only by the mercies of weather patterns that dictate hurricane paths. We in no way wished for it, but our economy may benefit from Katrina. Texas Gulf Coast ports are handling some of the trade that would have gone through New Orleans. Dallas may attract at least a few conventions that had been booked for New Orleans. Houston-area oilfield-services companies are very busy in the Gulf, and some New Orleans companies have rented a portion of the city's vacant office space. They may stay on permanently, as may a number of the evacuees.

Prior to Katrina, Texas' economy had been performing well. Positive signals have been coming from the Dallas Fed's Texas Index of Coincident Indicators, which has been rising for two years now. Our other barometer, the Texas Index of Leading Indicators, measures the outlook for the

state's economy. When you look at the trend and ignore the month-to-month wiggles, it, too, has been moving generally upward for about two years.

What happens here is not unimportant. I like to remind my international friends and anybody from New York that we are the second most populous state in the union, with the second largest representation in Congress. If we were a nation, our economy would be the world's 10th largest. Our state product exceeds India's GDP by 21 percent and Korea's by 23 percent.

So how are the various sectors of the Texas economy doing?

Texas retailers tell us sales have been strong, although they worry that higher prices for gasoline and other energy products may pinch consumers. Trade has been going well, too. Although flat in the first quarter, Texas exports have been robust for much of the past two years, a tribute to the state's competitiveness.

Our growing economy is putting an increasing number of people to work. The most recent data available indicate that Texas payroll employment had increased for 10 straight months, reaching a total of more than 9.6 million workers. The prime sources of new jobs have been construction; wholesale and retail trade, transportation and utilities; education and health services; and government.

While manufacturing jobs rose from June to July, the state's factory employment of 891,000 remains more than 15 percent below its level five years ago. The trend is what we should expect at a time when manufacturing is migrating to China and other low-cost centers of production. The Texas industrial production index fell in June and July, dragged down by lower output for both durable and nondurable goods. Despite these two months of modest declines, the index remains higher than it was a year ago.

Housing has been much in the news. Those of you watching the skyrocketing prices on the East and West coasts may feel that Texas has been left out. Well, it has. Over the past five years, our home prices have risen less than half as much as they have in the United States overall. When it comes to price appreciation, Dallas ranked 175th and Houston 226th among 248 metropolitan statistical areas in the second quarter. Key reasons are the abundance of available land and relatively modest restrictions on building. Strong housing demand has created a housing boom of another sort in Texas—not in home prices but in homebuilding. Over the past year, Texas issued more building permits for single-family homes than at any time since 1980 and more than any state except Florida.

Bob Hankins, the head of banking supervision at the Dallas Fed, is a worrier—that is what we pay him to do. Commercial real estate is one area that often keeps him tossing and turning at night.

Our contacts in the business community are telling us that commercial projects continue to gain steam—in part because Texas' competitively priced markets are attracting capital from more expensive coastal cities.

Office markets are improving. Occupancy rates in Texas metropolitan areas are starting to firm, although they are still low compared with other parts of the country. Our contacts say rents are

“firm” to “rising.” Houston and Austin show limited office construction activity, but speculative space is being developed in the Dallas area, despite its having the nation’s highest office vacancy rate. Industrial construction activity is also picking up, especially near the Port of Houston.

Despite the encouraging signs, commercial real estate fundamentals have been weak since 2001, when vacancy rates soared and rents declined as a result of the technology and telecom busts, the recession, the shocks created by terrorism and war, and the tepid economic recovery. Most of Texas’ commercial real estate markets have seen fundamentals begin to stabilize, but they remain sluggish by historical standards.

Not to be deterred, investors of late have turned to real estate as a relatively safe haven and may now be paying too much for commercial buildings. So there are rumblings from some quarters of a price bubble in the market. Meanwhile, banks continue to increase their exposure to commercial real estate loans. At banks in the Eleventh Federal Reserve District, commercial real estate loans accounted for more than 25 percent of total assets as of June 30. To date, delinquencies here remain low; however, this high concentration could portend a challenging operating environment for banks and bank supervisors in the days ahead. By way of comparison, during the regional banking crisis of the late 1980s, commercial real estate exposure in the district peaked at only about 15 percent.

No review of the Texas economy would be complete without a word about the industry that made the state famous. Oil and gas no longer occupies the legendary place it once had in the Texas economy, but it has been a positive factor as high prices have spurred drilling activity, especially for natural gas. Despite shortages of equipment and key skills, the overall rig count has climbed above 600 in recent months, up by two-thirds since the end of 2002 to a level unseen since the 1980s. With China growing at better than 9 percent a year and the 1 billion people of India working hard to catch up with Texas in economic might, we can expect continued strong global demand for energy, which will keep pumping up the Texas oil and gas industry.

Moving Toward a Globalized Economy

Before coming to the Fed in April, I ran a Dallas investment firm—one that, by the way, bought securities in distressed banks—and I was a trade negotiator. Both experiences taught me that what happens in other countries matters to the U.S. economy—sometimes quite a bit. We cannot fully understand our economy without appreciating how it interacts with the rest of the world. Simply put, we live in an era of globalization, and policymakers must come to grips with it if we are going to fulfill the mandate for policies that promote strong growth with stable prices.

A globalizing economy is one increasingly open to the movement of goods, services, capital, people and ideas across borders. A relatively straightforward way to show the trend toward globalization involves looking at trade as a portion of GDP. The ratio stood just above 27 percent in the second quarter of this year. In 1960, it was just 8 percent. To get some perspective on what wags the economy, I like to compare trade with the Pentagon’s budget. For most of the 1950s, defense spending exceeded trade as a share of GDP. This relationship began a reversal in the late 1960s, and the gap between trade and defense has grown in each decade. Today, even after the spending increases of recent years, defense outlays are slightly less than 4 percent of GDP, or a mere seventh of trade.

Increased globalization raises questions about traditional policy concepts and tools. One of my first acts as Dallas Fed president was to direct the bank's research staff to explore how globalization is changing economic fundamentals and the constraints on monetary policy. The current issue of our publication *Southwest Economy* lays out in some detail many of the issues and questions we are going to be addressing, some of which I will mention here.

We are pondering whether traditional measures of capacity utilization have much meaning in an increasingly interconnected economy. We wonder whether our traditional domestic gauges of slack in the economy are adequate in a world where new technologies made or used overseas make certain U.S. factors of production obsolete. And if we don't have a good handle on effective capacity, how can we measure how much of that capacity is being utilized?

Is the concept of the natural rate of unemployment—the rate that doesn't stoke inflationary fires—still meaningful in an increasingly globalized economy? If so, how is it affected? Could the ability of goods, services and people to flow across borders allow our economy to expand at a quickened pace, even if the unemployment rate falls below what economists traditionally thought was the natural rate?

When August's unemployment rate fell to 4.9 percent, for example, should we have concluded that labor has become scarcer and wage inflation might suddenly rear its head? Or does an interconnected world, where we have the ability to draw on labor resources from other countries, mean we can drive the domestic unemployment rate lower without stoking the fires of inflation?

In a similar vein, it has long been recognized that swings in the prices of energy and other commodities can shift the Phillips curve trade-off between inflation and unemployment. But how should domestic policymakers respond when commodity prices are determined largely by unpredictable swings in overseas activity?

I raise these issues as questions rather than conclusions because we at the Dallas Fed do not yet have all the answers. We do know that new eras require new thinking. The Dallas Fed intends to make a positive contribution to understanding how America's economy can benefit from globalization, rather than become a victim of it.

Coping with globalization will be a long-term issue—for both the national and Texas economies. Dealing with the aftermath of Katrina and rebuilding the battered Gulf Coast will be a major test of our national character for months to come. America has a history of rising to the occasion, and I fully expect this nation will shine once again in response to the challenges before us.

Thank you.